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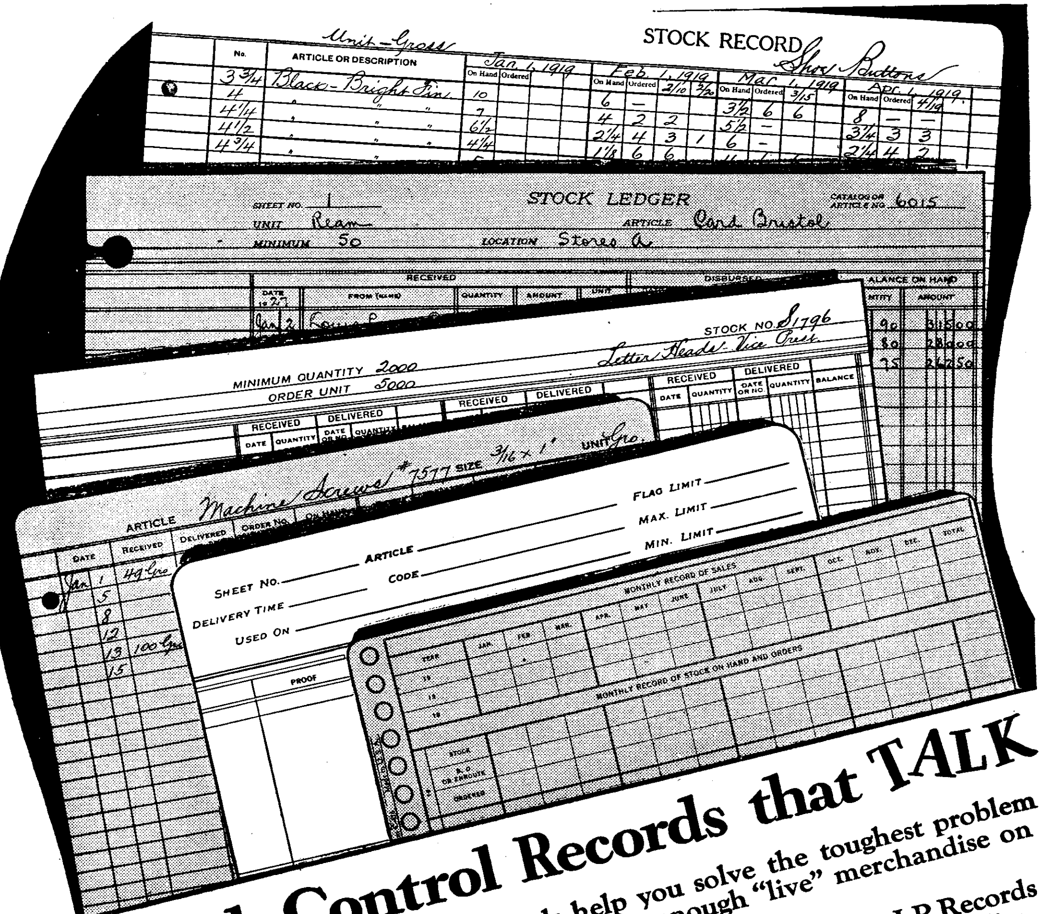
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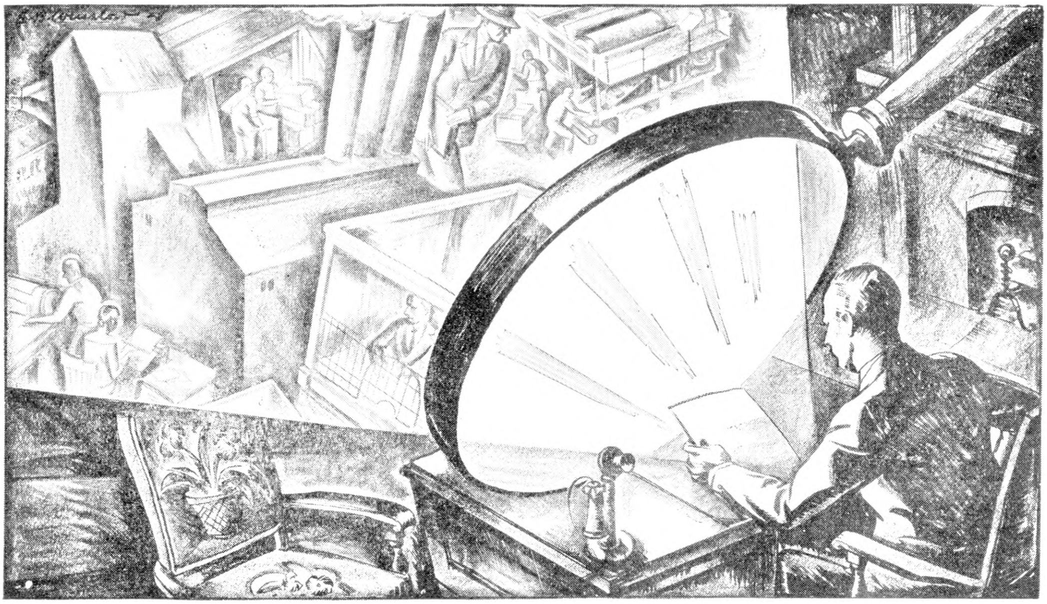

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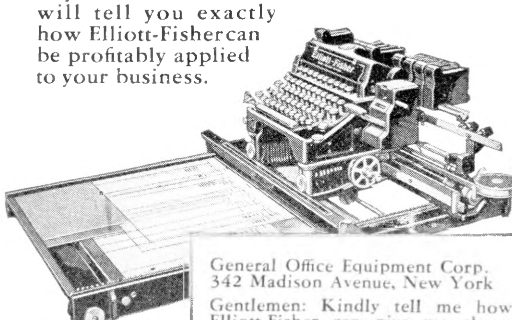

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No-par Stock and Asset Valuation*

BY FREDERICK H. HURDMAN

Before dealing specifically with the points involved in the question of asset valuation and its relation to no-par-value stock, allow me to reiterate, briefly, a few of the arguments advanced for and against this type of stock.

Perhaps the main argument advanced for no-par-value stock is based on a condition which has a very distinct relation with the subject of this paper, namely, the overvaluation of assets which prevailed prior to the passage of no-par statutes. This overvaluation was due to the fact that in most states par-value stock could not be issued at a discount and that corporations whose stocks were selling substantially below par, wishing to raise capital without encumbering themselves with funded debt, were compelled to resort to a legal evasion of the prevailing statutory provisions. The most common form of evasion was that in which assets, very often intangible, were sold to the corporation in exchange for par-value stock of a face value considerably greater than the real value of the assets acquired. The vendor would immediately donate a large portion of the stock so issued to the corporation, which would then proceed to sell it at a discount for the purpose of raising the required working capital. It will be quite apparent that this caused an immediate overvaluation of assets which was reflected in the capital and surplus accounts.

The second outstanding argument in favor of no-par-value stock is that many investors were misled by the one-hundred-dollar sign on the face of a par-value certificate into believing that the certificate represented net assets of at least that value in the corporation, whereas, in many cases, the actual value of the interest represented by the certificate was considerably more or less than its face value.

* Address delivered at a meeting of the North Carolina Association of Certified Public Accountants.

It was held by the proponents of no-par stock that no such erroneous impression would be given by it, but that prospective purchasers would realize that they were acquiring a definite fraction of the net asset value of a corporation as represented by its capital and surplus accounts and, of course, a proportionate interest in future profits.

This was a strong argument in 1912 when stocks were held, for the most part, by comparatively few persons, all competent or at least partly trained to estimate the actual value. It applies even more strongly now when we find such a vast number of stock transactions conducted on behalf of amateur speculators who have little or no financial knowledge.

Another point in its favor, when considered from the viewpoint of the stockholder of the latter type, is that, whereas many of the old par-value stocks were only partly paid and carried with them a liability to assessment, almost all no-par stock is fully paid and many of the states now provide that all such stock issued must be fully paid and non-assessable. There is, in any case, little point in issuing no-par-value stock which is not fully paid when the same purpose can be served by the issue of a smaller amount of stock at the start and the balance as and when it is found necessary.

When we turn to the arguments against no-par stock we find that from the theoretical point of view no really serious objections exist, but that a deplorable lack of coöperation between those who have framed no-par-value statutes and the accountants who were most competent to advise them has resulted, temporarily, in a certain number of practical difficulties. These difficulties have been augmented by those arising from a lack of uniformity in the laws as between states.

You will notice that I have used the term "temporarily" in referring to these difficulties, for I feel that no-par-value stock serves a very definite purpose both financially and economically, and that coöperation between state and national accounting organizations and lawyers can straighten out most of the present difficulties. Probably the accountant runs into most difficulty, in dealing with no-par stock, in setting up the capital and surplus structure where recapitalization or mergers have taken place.

It does not need any words of mine to demonstrate to a body of accountants the thoroughly unsound practice involved in the payment of dividends out of capital, and yet it is a surprising fact that in many of the states the legal provisions relating to no-par-value stock appear to justify the return to the stockholders, as dividends, of part of the capital originally contributed by them, and that there is at least one state in which there appears to be no legal obstacle to the return to them, as dividends, of the whole of the capital they originally subscribed.

Another objection raised from time to time is one closely allied with that just mentioned. It is based on the danger of infringing on the rights of creditors to have the original capital left in the business. North Carolina appears to have provided for this in its statutes by the provision that dividends shall not be paid when a corporation's debts exceed two thirds of its assets.

It is noteworthy that certain states, with the most carefully constructed laws relating to par-value stock and the protection of the rights of creditors and stockholders thereunder, have dealt with the statutes relating to no-par-value stock in the most casual and cursory manner.

Preferred stock of no par value is another of the points on which considerable discussion has occurred. By preferred I mean, principally, stock having preference in liquidation. Many difficulties have been encountered in the treatment of such stock and it appears to me that these are not so much due to any fault in the no-par-value principle as to an attempt to apply this principle to a class of stock with which it is entirely inconsistent. The whole principle is, as I have stated above, that a stockholder should regard his stock certificate as representing a definite fraction of the net assets as represented by the capital and surplus accounts. The value of the surplus account varies, of course, from day to day and the capital account may also be subject to frequent changes in value. How, then, can a share of preferred stock, having a fixed redemption value, be considered as a definite fractional part of the capital and surplus?

It is held by some that overvaluation of assets still exists and that it is caused by a desire to show large capitalization. This is unquestionably true, but I feel sure that in cases where it does exist in companies with no-par-value stock it is due to a definite intention to mislead the public, whereas, in the case of par-value stock, it arose, in addition, from the practical necessity of evasion caused by law.

The opponents of no-par-value stock have pointed to the abandonment of the principle by the General Motors Corporation, but when we come to look into the cause for the abandonment we find that it was due, not to any dissatisfaction with such stock, but rather to the necessity for evading a difficulty caused by the arbitrary stated value that the corporation had placed upon its shares.

OUTSTANDING PROVISIONS OF THE NORTH CAROLINA LAW

Turning to the laws of North Carolina with reference to no-par-value stock we find that any corporation not a bank, trust company, railroad or insurance company may create no-par-value stock both with and without preferences. The legal provisions relating to the issuance of par-value stock apply to no-par stock and the latter may be issued for such consideration and on such terms as may be fixed by the board of directors acting within its powers. The consideration must be in the form of cash, property, tangible or intangible, services and expenses, and no-par shares shall be fully paid and not liable to assessment.

The provisions found in the laws of many states regarding stated capital, stated value per share of no-par-value stock and liability of directors for debts until the stated capital has been paid in, are not found in the North Carolina law. There is, however, a very definite statement as to the intent of the law. This statement says:

> "The intent and purpose of this article is to require a share of stock to be treated and represented . . . as a mere evidence of an aliquot part or divisional interest in the assets and earnings of the corporation issuing the same, . . . to the end that misrepresentation or misunderstanding arising through the difference between the actual value of a share of stock and the value appearing on the face of the certificate therefor may be eliminated."

In addition to the specific no-par-value stock provisions, the following extracts from the general corporation law also appear to apply to no-par-value stock and to be of interest:

> 1. "Nothing but money shall be considered as payment for any part of the capital stock . . . except as herein provided: . . . Any corporation may issue stock for labor done, personal property or real estate, or leases thereon, and, in the absence of fraud in the transaction, the judgment of the directors as to the value of such labor, property, real estate or leases shall be conclusive."

Relating to mergers and consolidations we find that

> 2. "The rights of creditors . . . shall not in any way be lessened or impaired by the consolidation of two or more corporations under the provisions hereof."

The declaration of dividends is covered as follows:

3. "No corporation may declare and pay dividends except from the surplus or net profits arising from its business or when its debts, whether due or not, exceed two thirds of its assets, nor may it reduce, divide, withdraw or in any way pay to any stockholder any part of its capital stock except according to this chapter."

ASSET VALUATION

I have already referred to the deliberate overvaluation of assets that was prevalent prior to the institution of no-par-value stock, and to the suggestion that it would be checked by the introduction of this stock. Let us now look into some of the difficulties involved in valuation.

In comparing the valuation of assets represented by par-value stock and of those represented by no-par-value stock, we immediately encounter an important difference in treatment. In the case of par-value stock it is the stock that is valued, and assets should theoretically exist to the amount of the valuation placed upon the outstanding stock. In the case of no-par-value stock, however, it is the assets which are valued and the net asset value is automatically the value of the total shares outstanding as represented by capital stock and surplus accounts. It is obviously sounder that the assets should be valued, and this was, of course, one of the main arguments for no-par-value stock.

The responsibility for valuation varies considerably as between states, but the provisions prevailing in North Carolina are not uncommon, namely, that the consideration shall be cash, labor or property, and that, subject to the absence of fraud, the valuation approved by the directors shall be conclusive. This appears to be perfectly sound and yet it is surprising that many difficulties are encountered which could be overcome by the exercise of a little business foresight. One difficulty arises from the failure of those drafting agreements relative to the issue of stock to segregate and value the assets taken over. Cases will be found where, for instance, 50,000 shares of no-par common stock will be issued for a mixed aggregate of net assets valued at half a million dollars, and the accountant will be faced with the problem of finding out exactly how half a million dollars may be apportioned among the assets actually taken over.

Another difficulty arises from the valuation of intangible assets. Here, of course, a little more care is necessary in the case of no-par-value stock than was formerly called for in the case of par-value stock, for, whereas under the latter the goodwill account, for instance, was the convenient dumping ground for differences between the par value of stock and the net tangible assets, some attempt must now be made to value the intangible assets in order to arrive at the book value of the stock.

Still another difficulty arises in cases where the plan for recapitalization or merger provides for a segregation of capital and surplus which offends good accounting practice.

It can not be claimed that no-par-value stock has altogether eliminated overvaluation, for there is, undoubtedly, a tendency among certain companies to inflate asset values in order to increase their apparent capitalization. This applies particularly in the case of mergers, where four or five corporations with aggregate net assets of $5,000,000 book value will suddenly merge and reappear as one corporation, the outstanding no-par or even mixed capital stock of which will appear at a valuation of seven or eight million dollars.

Asset valuation is, of course, also affected by any adjustment of the books to reflect an increased or decreased valuation on appraisal in exactly the same way as it would be in the case of a company with nothing but par-value stock.

Let us now turn to the other side of the statement and look at the effects of these valuations and revaluations.

Starting with the extreme, we find one body of accountants which says that since a share of no-par stock represents a certain fraction of the net assets of a corporation it is necessary to show only one figure, namely, capital stock, on the liability side of the statement to represent the valuation of the net assets. The obvious objection to this is, of course, that no trace is kept of the amount available for undistributed dividends and that there is danger of distribution of capital. Next comes a group, whose views I personally share, which believes that the only segregation necessary in most cases is one between capital and earned surplus. However, I can appreciate the argument of the third group, which sees the necessity for a further distribution of capital between capital and capital surplus, but I can not accept the complete segregation urged by the fourth and extremist group, which seems to think it necessary to segregate the whole of the capital according to the purposes for which it was issued.

To my mind the stockholder is interested in knowing:

a. The total book value of his stock.

b. The portion of this book value which represents permanent capital and which he can not expect to recover except by sale.

c. The portion which he may expect to recover in the form of dividends.

If he desires to know how this net value is made up he should refer to those sections of the balance-sheet dealing with the specific assets and liabilities.

Segregation is, of course, necessary where more than one type of stock is issued, as, for example, where par-value and no-par-value stocks are issued, or where common and preferred stocks of no par value are found. In the former case the par-value stock must be first valued and the excess of net asset valuation over this par value will automatically represent the value of the no-par stock issued. In the latter case the redemption value of the preferred stock should be deducted from the net asset valuation in order to arrive at the valuation placed upon the no-par-value common stock.

It is contended by some accountants that the paid-in value and not the redemption value of preferred no-par stock should be set up. Why, they ask, should we set up a valuation on the preferred stock that it will reach only at liquidation or retirement? My reply is that a stockholder would wish to know the value of his stock, preferred or common, for one of two reasons: either to know what it would be worth if he sold it or to know what it is worth to hold it. If he wants to sell it, and it is a listed stock, the last place he should go to for a valuation is the balance-sheet, and so the redemption value can never deceive him from that point of view. If he wishes to hold it he is interested only in knowing what its value is in case the company should decide to cease business.

Difficulties will, of course, occur if mixed issues of no-par stock are exchanged for assets and the appropriate agreements do not state the amount of asset value applicable to each class of stock.

In considering the treatment of surplus that may arise from asset valuation or revaluation we must keep in mind, first, the sound accounting axiom that dividends should be paid only out of earnings—an axiom upon which the set-up of capital and earned surplus is based—and, second, the provisions of the North Carolina law which state that no corporation may declare dividends except from the surplus or net profits arising from its business, and that the rights of creditors shall not be impaired by the consolidation of two or more corporations.

It would appear, according to the law, that any surplus arising from revaluation could be credited to a capital-surplus account and be distributed in the form of dividends, but such a course is not in agreement with good accounting practice. In the case of a merger any inflated value placed upon the assets would be reflected in the capital and surplus accounts, and in many states having no-par statutes there is little to prevent the subsequent distribution as dividends of the amount of this inflation reflected in surplus.

Now let us take some specific examples of the difficulties which may occur.

Assume three companies, A, B and C. As of December 31, 1927, they decide to merge. At that date their position was as follows:

	Capital	Earned surplus	Net worth
A	$100,000	$100,000	$200,000
B	300,000	500,000	800,000
C	600,000	400,000	1,000,000
	$1,000,000	$1,000,000	$2,000,000

For the sake of simplicity we shall assume that each of these companies has nothing but par-value stock at $100 per share.

Prior to amalgamation the assets and liabilities of the three companies are valued, and the following revaluation of net assets is agreed upon:

A	$500,000
B	1,000,000
C	1,500,000
	$3,000,000

These valuations are segregated in the agreements and applied to the appropriate assets and liabilities.

In the first instance we shall assume that the plan of merger is that corporation C shall recapitalize and shall obtain powers to issue 60,000 shares of no-par common stock. This it issues as follows:

10,000 shares to the shareholders of A in return for the surrender of their 1,000 par-value shares
20,000 " " the shareholders of B in return for the surrender of their 3,000 par-value shares
30,000 " " its own shareholders in return for the surrender of their 6,000 par-value shares

Corporation C cancels all the surrendered stock and is left with 60,000 shares of no-par common with net asset value of $3,000,000.

How shall this $3,000,000 be segregated on the balance-sheet? Corporation C has a distributable earned surplus of $400,000, and the revaluation of assets gave it a capital surplus of $500,000. Corporations A and B had an aggregate earned surplus of $600,000, but since they have sold their net assets to corporation C this previously earned surplus automatically becomes capital and is, therefore, not distributable in the form of dividends. Why, then, should this inequality of treatment arise? It arises from the fact that so far as the shareholders of A and B are concerned they have liquidated their company and have received stock of corporation C as consideration for their capital and surplus. The shareholders of corporation C, on the other hand, have merely changed the form of the paper acknowledging their interest in the capital and surplus accounts of their corporation and are still left with the same amount of capital and undistributed earnings.

The shareholders of A and B would probably protest against the capitalization of their available earned surplus, but their remedy is, of course, to sell such portion of their holding in corporation C as was issued for their share of the surplus of corporations A and B.

Many merger agreements overcome this objection by providing for the creation of a surplus fund equal in amount to the aggregate earned surplus of the underlying corporations, and nothing in the North Carolina law would appear to prevent the distribution of such a fund in the form of dividends.

The set-up, so far, could be as follows:

Capital stock—60,000 shares of common stock of no par value	$2,600,000
Earned surplus	400,000
	$3,000,000

or

Capital stock and surplus		
60,000 shares of common stock of no par value		$2,000,000
Surplus		
Undistributed surplus of underlying corporations at time of merger	$600,000	
Earned surplus—corporation C	400,000	1,000,000
		$3,000,000

or in cases where the agreement provided for the setting aside of the aggregate surplus of A, B and C, as above outlined:

Capital stock—60,000 shares of common stock of no par value	$2,000,000
Surplus—initial surplus at time of merger	1,000,000
	$3,000,000

When the latter treatment is adopted, care must be taken to keep the initial balance separate. A profit of $500,000 on the first year's operations of the amalgamated companies and a dividend paid of $600,000 would be shown as follows:

Capital stock—60,000 shares of common stock of no par value...		$2,000,000
Surplus		
Initial surplus at time of merger...............	$1,000,000	
Add: Profit for year........................	500,000	
	$1,500,000	
Deduct: Dividend............................	600,000	900,000
		$2,900,000

We frequently find provisions in merger agreements in direct conflict with sound accounting principles. I will give just one example which could arise under the laws of North Carolina.

The merger agreement might provide that the net assets of A, B and C be taken over at the appraised value of $3,000,000 for 60,000 shares of no-par stock to be allocated as follows:

Capital................	$1,000,000, the original asset book value
Capital surplus.........	1,000,000, the increase in value due to appraisal
Earned surplus	1,000,000, the original earned surplus

I can not see anything in the existing law to prevent such a situation or to prevent the subsequent distribution of the $2,000,000 surplus as dividends. The rights of creditors of the original corporations would not be impaired, and it is specifically provided that dividends may be paid out of surplus, whereas, by all sound accounting theories, only $400,000 should be distributed. When a situation of this kind occurs, in which there is no illegality, I do not see that the accountant has any alternative but to follow the instructions dictated by the appropriate merger deeds.

The most advisable set-up in the above circumstances would probably be as follows:

Capital stock and surplus		
60,000 shares of common stock of no par value.............		$1,000,000
Surplus		
Capital surplus...........................	$1,000,000	
Earned surplus—initial surplus at time of merger................................	1,000,000	2,000,000
		$3,000,000

Compare this with the set-up dictated by what may be considered sound accounting principles.

Capital stock	$2,600,000
Earned surplus	400,000
	$3,000,000

If, instead of the absorption of corporations A and B by C, corporation D had been formed with an authorized capital of 60,000 shares of no par value and if this corporation had issued this stock in the same proportion as before in exchange for the stocks of corporations A, B and C, a slightly different situation would exist.

There would here be no question of existing earned surplus, and the set-up I should, myself, recommend would be:

Capital stock—60,000 shares of common stock of no par value	$3,000,000

Should the merger agreement provide for the setting aside of existing surplus, the set-up would be:

Capital stock—60,000 shares of common stock of no par value	$2,000,000
Surplus—initial surplus at time of merger	1,000,000
	$3,000,000

Specific allocations of the issue by D, as between capital, capital surplus and earned surplus, would result in the same set-up as was advocated in the previous example of this type.

Let us now consider the revaluation of assets.

Take the specific example of a corporation with net current assets of $5,000,000, fixed assets of $25,000,000, capital of $20,000,000 and earned surplus of $10,000,000. The corporation has outstanding 200,000 shares of common stock of no par value. We do not try to stop this corporation from reappraising its current assets and actually insist on this being done. If it has its fixed assets reappraised by conservative and reputable appraisers at $30,000,000 I do not see how we can object to the use of this valuation on the books. Sound accounting practice requires that the unrealized profit of $5,000,000 be not distributed in the form of dividends, but here again we find the laws of many states do not conform to this practice, and in North Carolina, for instance, this amount could be legally shown as capital surplus or even surplus, and later could be distributed.

The set-up I recommend here, of course, is:

Capital	$25,000,000
Earned surplus	10,000,000
	$35,000,000

but if clients insisted on

Capital	$20,000,000
Surplus	15,000,000
	$35,000,000

I do not think that under the existing law we could object.

CONCLUSION

Before closing I should like to repeat that I think the theory of no-par-value stock, as applied to common stocks, is fundamentally sound and that such difficulties as are being encountered in its use are arising entirely from a more or less thorough misunderstanding of the accounting principles involved by those who draft the laws and by many of those who are encountering these problems.

To my mind the whole trouble could be eliminated by a few simple steps.

a. Uniform action by all states prohibiting the declaration and payment of dividends except out of earned surplus.
b. Definite understanding as to what does and what does not constitute earned surplus.
c. The adoption of a simple segregation on the balance-sheet in keeping with the above, viz. capital and earned surplus.

By far the most formidable of these is the second, and I would call your attention to a questionnaire recently issued by the American Institute of Accountants to its members and now under consideration by a special committee. This questionnaire contains twenty-five carefully worded questions on this subject and the resulting opinions should be of great value in the solution of the problems before us.

Stock-brokerage Accounts and Their Audit*

By Anson Herrick

The subject of this paper seems opportune. Yesterday the public became "market wise" and today has gone "market mad." It is not long since a million-share day brought Wall street to the front page. Today five-million-share days are sufficiently common to be classed with the story of the dog that bit the man, and this increase in the volume of Wall-street transactions is not the result of New York transactions alone, for the speculative mania of the public, or its investment acumen, if you prefer, from Seattle to Miami, from Los Angeles to Bar Harbor and from San Francisco to Chicago, helps to swell the transactions of the "street," and, further, causes a proportionate increase in the transactions of local exchanges. It is only natural that there should be a corresponding increase in brokerage-house accounting and that such increase should bring new problems, many of which the practising accountant is being called upon to solve. Your apparent interest in the subject might be said to be the order of the day.

I frequently hear the statement that the accountant who is not versed in brokerage accounting is not competent to audit the accounts of a brokerage house. I hear discussion of the great difficulty of such audits. I wonder sometimes if those who have not had occasion to study the problem might not be justified in an impression of an attempt to clothe the subject with an air of mystery. There is no mystery in the accounts of the stock broker or in their audit, but it is true that stock-brokerage accounting is a highly specialized branch of accounting and contains much that is never met in other fields. It is also true that an audit of stock-brokerage accounts requires, if it is to be safely and expeditiously accomplished, that the auditor possess a rather thorough knowledge of the principles and practices of the business as well as the theories and practices of the connected accounting. I know of no character of audit that is as hazardous, which requires, even of the well informed, such meticulous carefulness in every detail or which presents so many, and sometimes unavoidable, pitfalls.

* Address delivered at a meeting of the California State Society of Certified Public Accountants, November 14, 1928.

I think it fair to assume that there is a sufficient number of persons present this evening who are unfamiliar with brokerage accounting to justify, if not necessitate, a description of the business of stock brokerage and its accounts as a preliminary to the discussion of audit processes. Manifestly, such description must be brief, comprising only the barest outline.

A stock broker is a highly specialized type of broker, clothed by custom and practice with duties and responsibilities uncommon to the ordinary broker. Basically, a broker is one whose sole function is to establish a contact between a seller and a buyer. He may be the agent of either but, unlike a factor, he does not have the custody of the commodity offered for sale by, or purchased for, his principal; has no responsibilities in the settlement to be made between the buyer and seller, and has no lien upon the commodities as security for his service charge. A stock broker, however, has been clothed by custom with many functions and responsibilities and we find him acting not only as broker but as banker, as informal trustee and sometimes as principal.

The primary business of a stock broker is the purchase or sale of securities as agent for his principal or customer. A secondary business is the lending of money to his customer upon the pledge of the customer's security. In this matter he becomes a retailer of credit, as all funds lent to customers are as a rule obtained by the broker through borrowings from banks or others, directly or through other brokers, and by custom and special agreement he is privileged to use, as security for such borrowings, the securities of his customers; and as he borrows at wholesale and lends at retail he charges a higher interest rate to his customers than he is required to pay, profiting by the difference.

Customers' orders for purchase or sale are executed, usually, by purchases from or sales to other brokers, either (a) by personal contact at the exchange of which the broker is a member, or (b) by order to another broker for execution by that broker at some other exchange. In the latter case the relation of the first broker to the second is essentially the same as the relation of the customer to the first broker. In either case the broker effects the purchase or sale in the same way as if he were acting as a principal and by custom and exchange rules becomes obligated to pay for and receive securities purchased and to deliver and collect for securities sold. But in his dealing with his customer the rôle of broker is strictly followed, and there must be a full disclosure to the customer of how and where the security was purchased or sold and the exact price paid or received, and if execution was effected on an exchange of which the broker is not a member the name of the broker through whom the transaction was executed must be disclosed as well as the commission paid to him. In some cases the broker may, instead of buying or selling for a customer, sell a security to or buy it from him, and there is no rule more rigidly enforced than the rule that in such cases the broker must disclose his position as principal and that commission shall not be charged.

Transactions between brokers on the floor of the exchange are arranged with an absence of formality and a paucity of record which would seem to lead to error and uncertainty. A broker offers 1,000 shares of Steel at 90, another broker says "sold," each makes a pencil notation of the trade, and that is all. But errors are few, and failures to adhere to the oral bargain simply do not occur. On the next day the broker who sold must deliver the 1,000 shares, and the broker who bought must pay. Such is the inflexible rule of the exchange. And in connection with rules of the exchange I should like to point out in passing that one of the principal functions of a stock exchange is the formulation of such rules governing the conduct of its members as are calculated to enforce complete honesty and propriety, not only with respect to dealings between brokers but with respect to dealings between brokers and clients; and there is no despot, or ever has been, who has enforced his laws as jealously as does the modern stock exchange.

Aside from constituting a meeting place and a free and open market, the principal function of a stock exchange is the effecting of clearances for its members in much the same way as a bank clearing house clears for its member banks. During a day a broker will buy and sell many different securities from and to many other brokers. To settle with each broker individually would involve much useless passage of securities and cheques back and forth and an excessive demand for temporary credit. This is obviated by providing that the broker pay to or receive from the exchange only the net amount of all his trades for the day. A broker selling various securities for sums aggregating a million dollars and buying securities aggregating a million and a quarter dollars merely pays to the exchange the net difference. A similar procedure is followed with respect to the securities. A broker who has sold 1,000 shares of U. S. Steel to various brokers and has purchased from the same or from other brokers 800 shares is only called upon to deliver 200 shares. But there is a difference between the clearance of money and the clearance of securities. With respect to money all transactions may be consolidated, but in the case of securities each security must be treated separately, and the obligation of a broker to deliver 1,000 shares of Standard Oil which he has sold is in no way affected by the fact that during the same day he purchased 1,000 shares of California Packing. While this is so obvious as to seem not to call for reference, I stress the point because it is one of the things which create much of the complexity of brokerage accounting.

The stock broker executes two kinds of transactions for his customers: one, cash transactions, and the other, margin transactions. In the first the customer orders the broker to buy or sell, the order is executed and the customer delivers the security sold or pays the cost of the security purchased. The broker pays for the purchase, receives the security and delivers it to the customer or, if it be a sale, delivers the security, collects the proceeds and pays them to the customer.

In a margin transaction, the customer, upon ordering a purchase, pays only a deposit or margin, so that upon payment for the purchase the broker has in effect lent the customer the excess of the cost over the deposit, and retains possession or control of the security as collateral, usually immediately depositing it with his bank as collateral for a loan to repay him for the amount lent to the customer. A slightly different type of margin transaction is the short sale. In this case the customer orders his broker to sell a security which he does not own and accordingly can not deliver, and deposits at the same time a cash margin. In this case the broker lends the customer the security sold, in order that delivery may be made, and holds the money received for the sale, or if the broker, not having any in his possession, has to borrow the security in order to make delivery, he transfers the amount collected to the lending broker.

In the case of a long or purchase margin account there are two reasons for the requirement of a deposit from the customer. One is to protect the broker against loss, so that his loan to his customer shall be less than the value of the collateral. The other is to make up the difference between the cost and the amount that the broker can borrow on the collateral from his bank, thereby obviating the necessity of the broker's using any of his own capital.

In the case of a short-sale margin account there is but one purpose of the margin deposit, and that is to secure the broker against loss; so that the cash received by him will exceed the value of the security lent.

Where a broker executes a customer's order through a broker who executes it on another exchange he, in effect, merely transfers the order and the customer's margin deposit to the other broker and usually is not required to pay in full and receive, as would be the case if the purchase was made on the local exchange. In such cases, the broker, instead of borrowing from a bank to lend to his customer, is in fact borrowing from another broker in the same way and under the same conditions as his customer has borrowed from him.

As already indicated, the amount of a margin deposit required by a broker is, or should be, sufficient not only to protect him safely against loss but to make up the difference between the cost of the security and the amount which the broker may borrow on it from his bank. A decline in the market value of the security reduces its collateral value, and when this happens the broker requires an additional deposit, or "calls his customer for more margin," in order that his margin of protection may be sufficient and so that he may reduce his borrowing from his bank in order that the bank's margin of security will not be impaired. Should the customer fail to make such additional margin deposit, the broker, by custom and agreement, is privileged to sell his customer's security and liquidate his loan to his customer from the proceeds. In the case of a short sale, the broker having lent the security sold, it is an increase in the market value of a security which impairs the broker's margin of security and necessitates a requirement for a further deposit by his customer.

The transactions of a stock broker are limited, aside from trading for his own account, to payments and collections for account of his customers for securities purchased or sold, the charging to his customers of commission for services and of interest upon advances, and the payment of his expenses of doing business and of interest upon money borrowed. From an accounting viewpoint nothing could be simpler, and in fact the financial accounts of a broker and the related developing records are simple, both in theory and in practice. But the difficult problem is the problem of recording the securities which are connected with each and every transaction. It is necessary that the accounts record these with the same completeness as the money involved, and there is the complicating fact to be faced that each kind of security must be separately treated, whereas the value of all securities may be recorded in one term. This problem of the recording of securities is met by the employment of exactly the same methods as are used in the recording of the money—by debit and credit. That is, when a customer is debited for the cost of a security purchased he is coincidentally credited with the security itself in terms of shares and name (and not in its money value), and the broker from whom the security was purchased is debited for the security. When a customer pays the broker for a security purchased and receives it he is credited for the money and he is debited with the number of shares of the security delivered. This seems simple and productive of no complexity because it would appear at first blush that all of the securities with respect to which the customers have been credited should be on hand, and if such were the case it would be simple and the problem would be no different from the problem of the bank in keeping a record of its collateral held against its loans. But the securities which a broker "holds" for, or for which he is responsible to, his customers or others are not always on hand—in fact, usually are not—and it is the function of the security records to develop both (a) all securities which are due to or from any customer or broker and (b) the customers or others to whom, and in what quantity, the broker is responsible for each security, on one hand, and, on the other, where the securities actually are.

The requirement that all securities due to or from any customer or broker be continuously recorded is met by the normal ledger accounts. In making the entries in the ledger accounts with customers and other brokers, they are credited and debited (in terms of shares) for the securities concerned with purchase and sale money entries, and for securities received or delivered. Securities delivered to banks as collateral and securities on hand or due from transfer offices are not, except occasionally in smaller offices, entered in the regular ledger accounts, with the consequence that the ledger itself does not contain complete security debits and credits but omits securities on hand or at banks. This omission is similar to the omission from the old-fashioned ledger of the cash account, and in this case it was necessary to use the cash-book balance, comprising cash on hand and in bank, to complete the trial balance.

This record in ledger account of security debits and credits concerning customers and other brokers is accordingly not sufficient, and to meet the second requirement it is necessary to have a continuous record with respect to each particular security. (It should be apparent that in the ledger accounts the responsibility of a broker with respect to a particular security will appear in many different places.) To meet this requirement a form of record, variously called "security ledger," "position book," "guide," etc., is used. In this record there is an account or group of accounts for each security; in the account or group of accounts as to each security, each customer or other broker is credited for the number of shares for which the broker is responsible; a debit appears against each other broker or bank which owes the security to the broker, and an additional account of "box" or "vault" shows a debit for the securities on hand so that a complete balance is exhibited. To illustrate, a broker's account of California Packing will show he owes to or rather is responsible to John Smith and Henry Jones for 100 shares each and, on the other side, that 50 shares have been deposited as collateral with his bank, that 75 shares are due to be received from his New York broker, that 25 shares have been lent as an accommodation to another broker, that 25 shares are due to be returned by the transfer office and that 25 shares are in the box. The record develops the accountability of the broker as to each security and exhibits his accounting for that accountability.

Unfortunately, I think, the terms debit and credit are not used in brokerage accounting in connection with securities. Instead we find the terms "short" and "long." They mean the same things, that is, short is the equivalent of debit and long of credit, although long entries are always found on the debit side and short on the credit side. This fact and the nature of the terms seem to confuse many, and it is not remarkable, for it does seem strange that the box should always be "short." But this confusion can be largely avoided if shorts are always thought of as debits and longs as credits.

Now let us recapitulate the exhibition of the accounts at any closing period. The money accounts or the ordinary trial balance presents an ordinary exhibition. It shows cash accounts, customers' accounts, brokers' accounts, securities owned, fixture and equipment accounts and various expense accounts as debits, and on the credit side shows notes payable, brokers' accounts and customers' accounts, partnership capital accounts and a few income accounts. The exhibition is simple. As to securities, the ledger accounts themselves exhibit, with respect to each customer or broker, the securities due to or due from each. The separate security ledger or position book shows the same information except that instead of being arranged by customers or brokers it is arranged by securities, and this record additionally exhibits the securities on hand or on deposit with banks as collateral. It is this trial balance, or rather these trial balances, that we are called upon to audit.

The audit of brokerage accounts like any other audit resolves itself into the two phases of the audit of the balance-sheet and the audit of the profit-and-loss account. It is the audit of the balance-sheet which is most troublesome and most involved. I will attempt to outline, again with necessary brevity, the various steps in the procedure.

While, like any audit, the audit of a brokerage balance-sheet embraces a verification of the accuracy of each item of asset and liability, this verification as to all personal accounts must be far more complete than is usually required and generally necessitates a confirming reference to debtors and creditors. Additionally the long and short position of every customer and other broker must be correspondingly verified and confirmed.

The audit work must commence immediately upon the conclusion of the business of the last day of the month as at the end of which the audit is to be made. The first step is the actual examination and listing of all securities on hand in the two groups of margin securities and safekeeping securities, the latter class being those securities belonging to customers who have liquidated their accounts, which, accordingly, are not held by the broker as collateral but only for safekeeping. This examination will usually also disclose receipts for securities due to be received from the clearing house (being in process of transfer) and receipts from transfer offices covering securities sent directly to them for transfer. These should be separately listed.

At the same time as the box securities are counted a statement should be obtained from the broker's cashier showing all securities deposited with each bank as collateral against notes payable.

The next step, pending the completion by the broker's office of the customers' statements for the month, is the transmission to all banks, as well as other note creditors of the house, of a request for confirmation of the note liabilities as shown by the books. The request should be accompanied by a complete statement of the securities appearing to be held by the creditor as collateral. Coincidentally the integrity of all clearing-house receipts found in the box should be confirmed by reference to the clearing house and, as a rule, the integrity of receipts or other evidence representing securities in process of direct transfer should be verified by confirmation from the transfer offices. In some instances it will be practicable and satisfactory to arrange with the cashier that all securities returned from transfer offices after the date of the count be delivered to you in the original registered and sealed envelopes, so that by their original examination you may confirm the integrity of the transfer receipts.

There are two methods for the verification of customers' accounts. One is to have all statements delivered to you in duplicate immediately upon their completion. The originals are directly transmitted by you to the customers with appropriate request for confirmation to you of the accuracy of both the money balance and the long and short securities shown; the duplicates of the statements are retained by you. The other method is to permit the customers' statements to be regularly mailed and then to abstract, by reference to the customers' ledgers, separate statements in duplicate, on your own forms, showing only the money balance and the securities long and short. The originals will then be mailed direct to the customers, with request for confirmation. I consider the methods entirely optional, inasmuch as the only important thing is that you retain in your possession an exact duplicate of that which is sent to the customer and that you receive from the customer a certification of its accuracy.

Coincidentally with the foregoing work, statements should be prepared, from the accounts maintained with other brokers, of the money balances and of the long and short securities. These statements should be confirmed either by the original receipt by you of statements from the brokers concerned, or by transmission to the brokers of a copy of the statement, with a request for certification of the accuracy of the showings.

At this point you will have in your possession the following:

(a) Statement of the securities verified as on hand, including securities in process of transfer;
(b) Statement of securities held by banks as collateral;

(c) Statements of the money balances and long and short securities as to customers' accounts;
(d) Statements of money balances and long and short securities as to brokers' accounts.

With the understanding that when I refer to accounts with other brokers I embrace accounts connected with delays in deliveries and with stocks borrowed and lent, you now have a record of all long and short securities as shown by the books, and the next step is to determine that there is an equality between the longs and shorts as to each particular security. The most convenient way to verify this would be to check your records against your client's position book, but this is impracticable because the position book will be in continuous use, and aside from this practical objection the procedure would be unsafe. The best procedure is to develop your own position book, which for convenience may be developed upon columnar sheets, a column being allocated to each security. Then enter from your customers' statements, box count and other records, the number of shares long, in black, and the number of shares short, in red, or vice versa. It will usually be found that upon the completion of this record there will be at least some securities which do not balance; that is, the number of shares shown to be long will exceed the number of shares short, or vice versa. These real or apparent variations must be investigated; first by reference to your client's position book, with verification that any error in your records evidenced thereby is truly an error in your records and not an error of the position book. It will be impossible to explain all of the various things that may have to be done in verifying that every security balances, or in completely confirming that the failure to balance is correct, it being recognized that a failure to balance as to any security means, if the shorts are deficient, that a security has been actually lost, or if the longs are deficient, that a security is on hand or due to the broker, the ownership of which is unknown.

Upon the completion of the security balance, trial balance of the general ledger must be taken and it must be confirmed that the controlling account of customers is in agreement with the aggregate of the individual balances shown by statements which you have used as the basis of your security balance and that balances of note accounts and brokers' accounts are in agreement with confirmations which you have received from banks and brokers.

Bank balances must, of course, be verified by usual reconcilement methods, the best way, I think, being to proceed upon the basis of the reconcilement originally made by your client's office and to verify it by originally obtaining from the bank the bank statement and canceled cheques about the middle of the succeeding month. Equipment accounts and advanced expense accounts require sufficient investigation to determine the reasonable propriety of the account exhibitions, a matter in which it should be recognized that brokers are prone to conservatism in the matter of depreciating fixtures, in the elimination of accounting of advanced expenses, and in the absorption of costs of minor equipment into operating expense accounts.

In the event that your client maintains a trading account reflecting his purchases and sales as a principal, it is important that this account be thoroughly scrutinized and possibly verified in detail, the extent of verification back to original entries depending somewhat upon the extent of internal control existing within the office itself.

Reverting to requests for confirmation from customers, it will usually be found that from 65 to 85 per cent. will respond. The propriety of sending second requests to those who do not at first respond depends considerably upon circumstances, but where there are no circumstances indicating the requirement of second requests in all cases, the accounts from which confirmations have not been received should be carefully scrutinized, and second requests should be sent in all cases where the accounts indicate short securities or where the accounts, because of inaction, extent of securities long, or other reason which might be developed more by intuition than by anything else, seem to require such attention.

Let us recapitulate and see what we have accomplished. We have verified the integrity of cash balances, the accuracy of accounts concerning securities owned and other impersonal assets. We have received acknowledgments of the accuracy of all accounts with brokers and banks and we have received acknowledgments from a high percentage of customers and by scrutiny have satisfied ourselves of the absence of any indication of the necessity of making further requests from those who have not replied. In so far as our money balances are concerned they are fully verified. With respect to securities we have similarly verified, in connection with each separate security, that all securities for which your client is responsible to others as evidenced by his accounts, as substantially confirmed by acknowledgments from customers and entirely from brokers, are either on hand or on deposit with banks as collateral or are acknowledged by brokers or customers to be due your client. We have not verified, however, that every security for which your client is actually responsible is accounted for, and this is a matter which can not be covered completely. You have not confirmed, and it is almost impracticable to confirm, that there are not securities due to customers who, because there was no balance of money in their account, did not appear in the trial balance, with the consequence that there was no way in which you could have determined the existence of the account other than by a process of examination usually unjustified. This is a weak link in every brokerage audit.

I will just touch upon a few special matters to which attention is necessary. It is necessary for you to satisfy yourself that the accounts with customers are sufficiently margined. That is, that the market value of long securities is sufficiently in excess of the debit balance or that the credit balances of short-sale accounts sufficiently exceed the short securities. This can only be done either by an extension of the securities appearing long or short in a customer's account at market value or by a sufficient scrutiny of the account to confirm satisfactorily, without complete computations, that the margin is ample.

It is necessary to determine that your broker client is not using customers' free securities as collateral. In every case where a customer's account shows no debit balance, but shows long securities, the securities themselves are free and should be in the "safekeeping" box, because if they are in the bank then the broker is truly in the position of borrowing money upon a customer's collateral in excess of the amount lent. In some instances a difficult problem presents itself. A customer may have long securities greatly in excess of the amount necessary to secure his debit balance. In such a case the specific securities which are in excess of the amount necessary to secure the account should theoretically be in the box. Locally, it does not seem customary to enforce such a rule strictly and in many instances it is impracticable to do so. If it should be found, however, that the aggregate of the securities on deposit with a bank as collateral are just sufficient to secure the loan from the bank and that these securities embrace securities which really constitute surplus margin of a customer, then it would be clear that the broker was using surplus customers' margins for the purpose of borrowing money either for his own use directly or for the use of customers who are under-margined.

I shall not attempt to discuss the preparation of the equity balance-sheet form required by the San Francisco stock exchange. That in itself is a subject justifying a separate discussion. I will, however, touch briefly upon the attention necessary to the profit-and-loss account.

The audit of the profit-and-loss account is of relative simplicity. It should embrace an analysis of the commission account, together with sufficient reference to the records of original entry to satisfy yourself that the total commissions charged have been credited to the account. Detailed verification of the computations of commissions is unnecessary, barring the special case, but it is important to watch for any error which may have been made by your client in charging a commission upon his sale, as a principal, of securities to a customer. For this purpose the trading security account should be investigated and wherever it appears that sales have been accomplished directly to customers it should be confirmed that no commission was charged. This appears a minor matter, but it is one which might be of considerable importance to your client. Charges to customers for interest should be confirmed approximately by consideration of average debit balances and if the records of your client are well arranged it will be possible to confirm this to your entire satisfaction. Profits or losses from the client's own trading operations should be analyzed in connection with the analysis of his own trading account. All expense accounts should be scrutinized, all charges for salaries should be thoroughly vouched, and reference to vouchers should be made with respect to all irregular or important expense items. By these means you will have verified the completeness of the entry of income and the authenticity and propriety of all expenses.

To those of you who are familiar with brokerage accounts and their audit my discussion of brokerage accounts and practices will unquestionably appear unnecessary; to those who are not familiar with brokerage accounts it unquestionably will appear incomplete and inadequate. I am concerned principally with those who have had little or no experience in brokerage accounting and, while I recognize that for them it is incomplete, I hope that I have given some insight into the theories involved in the accounts and into the difficulties and requirements of audit procedure.

The Retail Method of Inventories*

BY J. P. FRIEDMAN

The "retail method of inventories" is the name applied to the type of perpetual-inventory records which is maintained in trading businesses on the basis of retail rather than cost price. Inventories at retail are used most commonly in organizations handling a multiplicity of items to which the ordinary method of maintaining a separate card for each item can not be applied because of the relatively small value of each item, the large number of transactions and the consequent prohibitive cost. Department stores have been the leaders in the development of the system of inventories at retail, although many other retail businesses, including chain stores, also use it to a considerable extent. In some of the departments of the modern department store in which expensive articles are sold, such as fur coats and furniture, detailed perpetual-inventory records by pieces often supplement the retail inventory records, but these are not carried out as fully as the accountant would wish: as a rule no attempt is made to tie them up with controlling accounts in the general ledger—they are approximate piece records only.

At an annual convention of the Controllers' Congress of the National Retail Dry Goods Association about eight years ago, the chairman requested a showing of hands by representatives of such stores as had adopted the retail method of inventories. The percentage was found to be comparatively low. At the convention of the organization held in St. Louis about three years ago, the same request showed that approximately two thirds of the stores represented had adopted the retail method, and probably the percentage today is considerably higher. This progress shows the marked appreciation by the retailers of the country of the advantages of using the retail method of inventories.

In discussing the subject, it might be best to give an explanation of inventories at retail, to outline the more important advantages and to describe some of the arguments which have been used against their introduction.

EXPLANATION OF THE RETAIL METHOD OF INVENTORIES

A great many people have approached the subject of retail method of inventories in the spirit of fear—as if it were a very

* Address delivered at a meeting of the St. Louis chapter of the Missouri Society of Certified Public Accountants.

difficult matter to comprehend. Quite the contrary is true: it is very simple and can be grasped readily.

The general aim is to know at all times the value of the inventory on hand at retail and the percentages of marking, mark-down, shortage and gross profit. Reports of these figures may be prepared weekly, semi-monthly, monthly or at any other regular or irregular interval. Retail prices are used throughout, cost being introduced only for the purpose of determining profits, as explained later. Separate figures on individual sheets are maintained for each department.

Explained in general terms, the retail inventory is based on the formula that the inventory at the beginning of the period at retail, plus the purchases for the period at retail—these adjusted by mark-ups, mark-downs and stock shortages—less the sales for the period at retail, gives the book inventory at the end of the period at retail.

The information necessary to compile the departmental figures is derived from the following sources:

Opening inventory. From the physical inventory taken at the beginning of the period priced at retail and reduced to "value" by the departmental percentages of marking.

Purchases. Upon their receipt from vendors, the invoices are sent to the checking and marking department, where the buyers receive those applicable to their departments, examine the merchandise and note on the invoices the retail prices per unit. From these notations, the markers prepare the price tags. The invoices are thereafter extended at retail, and are entered into the departmental purchase record both at cost and at retail, the total of the retail column being carried forward to the departmental inventory record.

Price-revisions. When the selling price of any article is to be changed, the buyer prepares a form showing the old price and the revised price per unit, the difference representing the amount of the revision per unit, which when multiplied by the number of units gives the amount of the revision. Separate totals are prepared for mark-ups and mark-downs.

Sales. This total is obtained, of course, from the daily audit of sales checks and other sales debits and credits.

Closing inventory. From the physical inventory taken at the end of the period and priced at retail.

The difference between the closing physical and book inventories will be the amount of the shortage or overage at retail. It has been found that after a few years the net amount of the shortages tends to become stable at a fixed percentage of the sales; this makes it possible to provide for the shortages periodically. In the departmental inventory form a column is introduced for the monthly estimate of this shortage, so that at the end of the year the book inventory will agree approximately with the physical one. A separate shortage rate, of course, is used for each department.

The closing inventory at retail may be reduced to "value" (i. e. cost or market, whichever is lower) by deducting from the retail value the average percentage of marking. This percentage is arrived at by subtracting from the total of the inventory and purchases at retail the total of the inventory and purchases at cost, and dividing the remainder by the inventory plus the purchases at retail.

From the point of view of the balance-sheet the correctness of the valuation of the inventory will depend, in the main, upon the correctness of the percentage of marking, since that is the percentage which is used to reduce inventory from retail to balance-sheet value. It might not be amiss, therefore, to lay particular stress on the method of arriving at that percentage and upon the common errors which have been found in the past.

It has just been stated that the percentage of markings is arrived at by subtracting from the total of the inventory and purchases at retail the total of the inventory and purchases at cost, and dividing the remainder by the inventory plus purchases at retail. For example, assuming for a given department an inventory of $11,000 at cost and $16,000 at retail and purchases of $39,000 at cost and $64,000 at retail, there would be a total inventory and purchases of $50,000 at cost and $80,000 at retail, representing a percentage of markings of 37½ per cent. (30/80ths). This is the percentage difference between the retail and cost price on the basis of the retail price and is the percentage of gross profits which the department would earn if it sold all the goods at the prices originally marked and if there were no theft, breakage and shrinkage. But it is well known that department stores do not succeed in disposing of all their merchandise at the prices originally marked; that there is theft, breakage and shrinkage, and that, consequently, the percentage of gross profit is considerably lower than the percentage of original marking. Mark-downs alone, according to published figures, average about 7 per cent. for department stores, so it is apparent that the gross-profit percentage is considerably lower than the percentage of original markings. Nevertheless, it is the percentage of original markings which is deducted from a department's inventory at retail to reduce it to "value". The higher percentage, of course, is the correct one, since it will be necessary to take mark-downs and to suffer theft, breakage and shrinkage of the goods remaining on hand, and provisions therefor must be made in arriving at the inventory values.

The situation might be explained in another way. It might be entirely satisfactory to arrive at the balance-sheet value of the inventory by using the percentage of gross profit if the ultimate net selling price of the inventory could be determined. But since the present price marked on the inventory is not the ultimate net selling price, and since such price can not be determined, the retail price at present marked on the merchandise is used and this is reduced by the percentage of original marking which admittedly is higher than the percentage of gross profit but provides approximately the same margin as in the past for expected mark-downs, theft and shrinkage.

Mark-downs are not brought into account in arriving at the average percentage of marking—they are not allowed to reduce the original percentage determined at the time the goods were first marked. The reason for this may be shown by the following illustration: If an article were purchased for $100 and marked by the buyer to sell for $150, the average percentage of marking would be 33⅓ per cent. If this article remained unsold and were inventoried at the end of the period, a deduction of this 33⅓ per cent. from $150 would result in a return to the cost of $100. Let it be assumed, now, that the buyer subsequently decided to mark the price of the article down to $140 and that the article still remained on hand at inventory time. If a new percentage were to be arrived at, it would be 28$\frac{4}{7}$ per cent. (40/140ths) which, when deducted from the $140 retail price, would bring the "value" back to the original cost of $100. If, however, the 33⅓ per cent. were left unaffected by the mark-down and that percentage were deducted from the new price of $140 this would result in a "value" of $93.34. It will thus be seen that changing the percentage does not reduce the retail price below cost, while deducting the original percentage does. But since it was necessary to reduce the sales price, the assumption is that the value has decreased below the cost of $100. Since inventories should be valued at cost or market, whichever is lower, in order under the retail method to bring the "value" of marked-down goods below cost, the percentages are not reduced as a result of mark-downs. In this case 33⅓ per cent. would be deducted from the $140 and the "value" of $93.34 would be used.

On the other hand, in order not to bring the "value" above cost in cases in which there are mark-ups, mark-ups should be brought into account in determining the percentages of marking—they should increase these percentages. Using the same illustration, if a $100 article which had been marked to sell at $150 were increased in price to $160 and the original 33⅓ per cent. were deducted from the new retail price, it would result in an inventory value of $106.67, which would be $6.67 above cost. This would mean the taking of an unrealized profit. If, however, the amount of the mark-up were included in the figures from which the percentage is arrived at, a new percentage, 37½ per cent. (60/160ths) would result, and this, when deducted from the $160 selling price (if the goods remained on hand), would give a "value" of $100, which is cost.

In short, the "value" of the goods remaining on hand should not be included at a figure in excess of their cost, even if the retail prices have been increased, but in the case of mark-downs the "value" should be reduced below cost. Thus, under the retail method, by excluding mark-downs from the percentage of marking, and by including mark-ups in that percentage, inventories will be valued automatically at approximately cost or market, whichever is lower.

Care should be taken to distinguish between mark-ups and cancellations of mark-downs. When goods are marked down for a sale and the original retail price is subsequently restored on the unsold merchandise this increase is not a mark-up, but a cancellation of the original mark-down. It should be treated as such; otherwise the inventory figures at retail reduced to "value" will be overstated.

So far the discussion has dealt with the handling of inventories at retail in the office. The figures prepared by the office, however, can be correct only if the office is furnished with correct information by buyers and merchandising executives. In many instances, unfortunately, this is not the case. If a buyer indicates an expected retail selling price on the bill, which is not the same as that placed on the price tag attached to the merchandise, the accountant will arrive at an incorrect percentage of original marking and a resultant inventory at cost or market, whichever is lower, which is incorrect.

The measure of the correctness of the information furnished to the office, omitting for the moment the question of clerical errors made in the office, which might occur in any perpetual-inventory records, is the variation from the book figures found when a physical inventory is taken. In many of the stores that have adopted the retail inventory method shortages averaging 2 per cent., 3 per cent. and sometimes even 4 per cent. of the sales are shown at the end of the year. These percentages, of course, are excessive and arise from the fact that the installation has not been proper or has been only partly made, or that the system as outlined is not being followed in whole or in part. These high percentages also usually fluctuate so widely from season to season and from year to year that it is impossible to provide for them in the record with any measurable degree of certainty. Such results are misleading and in most cases worse than none.

Probably the most common reason for large shortages is the lack of a proper method for recording price revisions both up and down. In some stores buyers with the aid of their own departmental employees do the physical marking and are instructed to turn into the office a complete list of the changes. Most frequently these instructions are not followed. If the mark-downs within a given week are unusually heavy, it is quite likely that the buyers will turn in a record of only part of them, expecting, at best, to send in the remainder during a subsequent week when the mark-downs are not so heavy, and hoping in this way to average the total by the end of the season—which may or may not be accomplished. Or they may turn in no more than a part record, preferring to have a shortage appear at the end of the year rather than to disclose the amounts of the mark-downs currently. The only method that has been found successful in getting a complete record of mark-ups and mark-downs is to have price revisions made by a marking staff not under the supervision of the buyers: such a staff will revise prices only upon the written instructions of the buyers on regularly printed, serially numbered forms, to which the buyers have no access after they have turned them over to the marking department with their signatures. Immediately after the price changes have been made the forms are sent to the office for extension and recording.

Similarly, inventory shortages arise in a large measure through buyers' doing their own marking of original purchases and showing retail prices on the bills different from those marked on the goods. Very often, in such cases, the prices marked on the goods are higher than those shown on the bills, so that the buyers may have ample margin for taking mark-downs which need not be reported.

In a great many stores reserve merchandise is stocked without each article being priced, the price being kept in a book—which may or may not be accurate—or in the buyer's memory. This causes errors which may be avoided by marking all goods immediately upon receipt.

The physical layout of the receiving, checking and marking room very often is not such as to insure proper record of all transactions. The receiving and checking operations should be entirely separated from the marking operation, and all of these in turn should be separated by an enclosure from the departmental reserve stock rooms. Some stores have had the receiving, checking and marking for each department done within the departmental stock room. This invariably leads to error—to the mixing of stocks. The better method is the one outlined above—the separation of the receiving, checking and marking room from the departmental reserve stock room.

It will, of course, never be possible to do away with shortages entirely, since the theft element is present, but it is possible to minimize them, as attested by the results of several stores that operate this system properly. In these stores the shortages at retail range from ½ to 1½ per cent. of the sales. In some of them percentages have remained almost constant for a period of years and when the monthly provision is taken into account, the difference between the actual physical inventory and the book inventory at the end of the year is practically negligible. Such a store always knows the exact conditions in every department and is in a position to plan intelligently with all the facts before it. It has a tremendous advantage over a store that operates without the retail method.

The problems of retail inventories are complicated by the fact that department stores which are essentially trading businesses almost without exception do some manufacturing. Examples are the manufacture of awnings and upholstered furniture, the trimming of ladies' hats, the alteration of clothing, and the conduct of restaurants and soda fountains. It is almost needless to state that in such instances it is necessary to segregate material, labor and overhead costs and to consider them in arriving at departmental percentages of marking. As distinguished from the actual creation of goods for sale, there are other types of manufacturing such as, for example, the repolishing of furniture prior to delivery and the alteration of garments after sale, both of which are done without charge. The labor is expended upon goods already sold; it does not apply to those remaining on hand. For that reason this class of expenditure can not be taken into account in arriving at the percentage of marking, as that percentage is used only for the goods remaining in the inventory. Material, labor and overhead on goods actually manufactured for sale, on the other hand, should be included with purchases in arriving at the departmental percentages of marking, as such expenditures are similar in all respects to the purchase of merchandise in the manufactured state from outside vendors.

In considering these workroom operations, the problem is first to determine when to exclude materials, supplies, labor and overhead from operating expenses, and, if excluded, when to allow them to affect the departmental percentages of marking and when not. A committee of the Controllers' Congress of the National Retail Dry Goods Association was appointed for the purpose of revising the *Standard Methods of Accounting for Retail Stores* which was adopted some seven or eight years ago and has not proved entirely satisfactory. It was noticeable during the discussions of the committee that many of the members of even such a committee, who were expected to be above the average in their knowledge of retail practice, were handling the situation incorrectly. The reason is not difficult to determine. Manufacturing is a relatively small part of the operations of a department store and consequently it has received little attention. For individual departments, however, the workroom operations form quite an important part of the total business and for these departments failure to handle properly the operations of the workroom will result in errors of considerable size in arriving at inventory values.

The theory and method of arriving at the correct departmental percentage of marking with which to reduce the inventory at retail to "value" have now been discussed, as well as the physical handling of the merchandise. The percentages of shortages must be scrutinized and if they are in excess of reasonable percentages the departmental percentages of marking should be examined carefully and perhaps be adjusted before being used.

The problem of obsolete and unsalable merchandise presents itself in retail inventories as in other types of inventories. In the progressive department store, the accountant has available a great aid in season symbols which are now used almost universally. A letter of the alphabet is assigned to each half-year and this letter appears on the price tags of all merchandise purchased during the period. In taking a physical inventory, the items are classified by season symbols so that the accountant can judge for the store as a whole and for individual departments whether the percentage of old merchandise is excessive or not. Upon investigation he may find that merchandise of this class has been reduced considerably in retail selling price and consequently that it may not be necessary to make any further adjustment in view of the fact that the original percentage of marking has been deducted from the lower selling price. In most cases, however, he will probably find, if there is an excessive percentage of old merchandise, that the retail prices at which such merchandise has been included in the inventory are not low enough to permit its sale. In such instances the auditor will find it necessary, without changing the departmental perpetual-inventory record, to provide a reserve on the general ledger for obsolete and unsalable merchandise.

ADVANTAGES OF THE RETAIL METHOD OF INVENTORIES

The advantages of the retail method of inventories—advantages which are responsible for its introduction in such a large proportion of the department stores throughout the country—are many. There is the advantage which is common to every perpetual-inventory system—the ability to prepare accurate statements of operations monthly instead of at the end of the year only. Remembering that a department store is really an aggregate of sometimes as many as several hundred departments—each of them in a sense a separate business conducted by a separate buyer who is interested in the results of his own department only—it becomes all the more important to know definitely what the operating results show and to be able to take immediate steps to rectify any unfavorable developments which may appear.

A number of advantages which are peculiar to the department store may be summarized briefly.

(1) Not only is information for each department available as to sales and purchases periodically, but also as to the inventory, the mark-downs and the percentages of marking. Having this information, the executives are in a position to control their business as closely as they deem advisable. They may predetermine what the inventories should be at given dates, set the average percentages of original marking or set limits for mark-downs. The executives through their wide experience are in a better position than are the buyers to set these limits so that the buyers know just what is expected of them. By this method, the executives, in addition to their physical contact with the merchandising operations from day to day, are able to get a bird's-eye view of the results at the end of the week and to know whether results are coming up to predetermined standards and expectations. The reports have the effect of concentrating the policies in the hands of the executives while leaving the buyers just as free as before to work them out.

(2) Comparatives from season to season and from year to year are furnished by these reports—comparatives which were, under the old system, carried in the memories of the buyers and executives. These are an invaluable aid. The retail method thus substitutes orderly records for memory.

(3) If the store operates a merchandise budget—planned sales, inventories and purchases—the retail method is of great importance in giving, at frequent intervals, accurate data of the stocks on hand with which to gauge purchases. Without the retail method, the determination of the periodic inventories must be based on average percentages of gross profit for long periods. These percentages, while perhaps accurate for these entire periods, are totally inaccurate for part periods, particularly in "style" departments in which frequent sales are conducted, since in such cases the percentages of gross profit at the height of the season are considerably higher than the average, and the deduction from sales of the average percentages gives an inflated view of the inventory.

(4) Marking labor is reduced through obviating the necessity of marking the cost or cost reference, in code or otherwise, on each price ticket—the retail prices only need appear.

(5) The movement of merchandise from the receiving rooms to the sales floors and stock rooms is expedited, and price revisions are made faster, since a coördinate routine is established.

(6) Physical inventories are taken with a facility unapproachable under the old method, because only retail prices need be recorded and all merchandise is plainly marked with retail prices. There is no reference to records and invoices for costs and retail prices, even in cases of reserve stock or obsolete goods. The inventories may be taken and checked by clerks other than the departmental employees. The total retail value for each department is reduced to cost by the departmental percentage of marking and the resultant figure is more accurate than if an attempt were made to show the retail price and cost of each article individually. This is particularly true in a declining market, when the departmental percentage deducted from the total retail value will give a truer "value" than the sum of the buyer's guesses as to the individual items.

ARGUMENTS USED AGAINST THE INTRODUCTION OF THE RETAIL METHOD OF INVENTORIES

A great many department-store executives do not fully understand the retail inventory method; they do not realize the advantages that would accrue to them from its adoption. Aside from inertia, lack of appreciation of these advantages has been the greatest factor in deterring stores from adopting it.

Some executives are under the impression that under this method additional expense must be incurred in marking the goods. I believe that the contrary is true. While the size of the marking staff and possibly even of the receiving and checking staff will be increased somewhat, there will be a corresponding, if not greater, reduction in the time which the buyers and selling staff devote to the checking and marking of merchandise.

A complaint usually heard is that the retail method does not give accurate results in departments that handle several classes of goods, some of which are sold at high and others at low percentages of gross profit. If only one class of these goods is left in the inventory, it is claimed that by deducting the average percentage of marking from the total retail price the resultant inventory at "value" would be too high or too low. It should be borne in mind, however, that within a given department, with very few exceptions, the high and low percentage merchandises tend to form about the same proportions of both the inventory and the purchases, and that, therefore, the percentage of marking is weighted in the same manner as the inventory. Further, as to the individual departments, the inventories at the beginning and end of the period and from period to period contain high and low percentage merchandise in about equal proportions, so that the error, if any, affects the balance-sheet but not the departmental profits. From the balance-sheet point of view, on the other hand, overvaluations in some departments will tend to offset undervaluations in others, so that the inventory as a whole will probably be correct.

Other executives have stated that the percentage of marking arrived at from the retail inventory records are not accurate when tested against actual pricings of the individual items of the inventory. It will usually be found, however, if the pricing of the individual items has been properly done, that those that have made this test do not arrive at the percentage of marking properly; they usually include mark-downs and sometimes even the shortages in arriving at the percentages. The average percentage for a department for a period of years varies little, and a fair test will show that the cost method and retail method will give approximately the same results.

There is a feeling that the retail method gives misleading results because the buyers take mark-downs and do not report them. This is not the fault of the system but rather a fault in carrying it out. The buyers should not be allowed to take mark-downs themselves. They should merely fill out price-revision forms—which should be serially numbered—and turn them over to the marking staff, which, after making the changes requested, will send the forms to the office, immediately obviating the possibility of tampering with them.

Others have complained that when special sales are planned to be held several months after inventory date, the reduced "value" can not be taken up under the retail method since it is not wise to mark the retail prices down immediately. Under the old cost method they were able to leave the retail price unchanged but reduce the cost. It should be remembered, however, that while the reduction can not be put through until the goods are actually reduced, there is no inhibition against setting up an inventory reserve on the general ledger for mark-downs of this character. This does not interfere with the retail method of inventories.

Some stores have been eminently successful without the retail method and their owners state that they have made more money than others who have adopted it. The answer to this is that they have succeeded not because of the lack of it, but in spite of this lack. Their superior organization and general business ability, sometimes coupled with an advantageous location, would probably have brought them even further along had they had the retail method of inventories as an aid.

A prominent store owner who had been operating the retail method for a number of years said some time ago that with all the complexities of his business he could not keep in touch with it if he did not have the retail method of inventories. He would not, he stated, otherwise be able to go to sleep at night and know that things were going along properly, but would always be afraid of unpleasant surprises at inventory time.

The retail method was evolved as a result of the necessity of the department-store business. It has been a tremendous aid to executives. The coming years will see its almost universal adoption and perfection by department stores throughout the country.

Some Economic and Historical Aspects of Taxation*

By Charles W. Smith

I

Taxation is indeed a prosaic subject. There is nothing in it to stir the imagination to poetic heights, to fill the fancy with dreams and visions, or to inspire the emotions with feelings sublime, for no one was ever known to go into ecstasy over the payment of his taxes. The subject is devoid of romance; it is cold and sometimes cold-blooded. It lacks the appeal of human-interest topics; it is, in other words, a part of economics.

The science of economics is generally divided into five classifications or headings, viz., consumption, production, distribution, exchange and public finance. Public finance, in turn, is divisible into two broad sections, public expenditure and public revenue, treated in the order named from the time of the publication of Adam Smith's *Wealth of Nations*, the first genuine treatise on economics. Governments, unlike business institutions, look first to what they deem it advisable to spend and only then to the means of procuring sufficient revenue to cover the proposed expenditures.

The sources of government revenues are varied, but the chief sources are taxes, fees, commercial revenues (such as water rents), gifts, fines and penalties. Taxes are by far the most important item and probably in the last decade have provoked more sweating, more profanity, more suffering and yet more prosperity in the accounting profession than any other single phase of economics ever caused that profession. But without the aid of taxation there would probably be no accounting profession, for there would probably be no governments. "Taxes," says Cicero, "are the sinews of the Commonwealth." Commercial intercourse within nations and on the seven seas could not be conducted in an orderly manner—in fact, all of the benefits of established government would not have come into existence—were it not for what has been termed this "potent engine." Civilization and taxation seem to go hand in hand. The former refuses to advance without the latter. So if we are to be civilized it seems we must pay for it. "Taxes and gruel," says a Hindu proverb, "continually grow

* Address delivered at a meeting of the Maryland Association of Certified Public Accountants.

thicker." And we are given a doleful reminder by Dickens that there is nothing certain but death and taxes.

No genuinely comprehensive definition of the word "taxation" seems available. None is needed. We all have felt the meaning better than it can be expressed. The idea of compulsion, however, pervades the word and is its chief characteristic. Dr. Ely says " . . . taxes are one-sided transfers of economic goods or services" and this agrees with Professor Taussig's statement that "there is no quid pro quo." The fact that there is no quid pro quo is probably the psychology back of Emerson's assertion that " . . . of all debts, men are least willing to pay the taxes. . . . Everywhere they think they get their money's worth except for these."

The economic aspects of taxation are probably few in number, but so deep, complex and involved as to have attracted some of the profoundest thinkers. The views and conclusions of authorities are not always in agreement and it is not to be expected that one of my humble attainments could arrive at solutions that would be worthwhile. Consequently, I shall content myself with reviewing the recognized principles of taxation, without any attempt at valuation.

First, there are two theoretical explanations of the justification of taxation. One is the benefit theory and the other the faculty theory. The benefit theory was the first to be advanced by statesmen and economists and holds that the tax should be levied according to the benefit conferred by the sovereign state. This does not mean that the tax should be assessed in equal proportion for it was considered that some individuals, men of wealth, receive larger benefits than others and should bear a larger share of the tax burden. But the relative benefit of human life defies measurement and as the protection of life is the first function of government, it follows that the benefit theory had to give way. With changes in the social order, the benefit theory was succeeded by the faculty theory. This theory holds that a tax should be levied not according to the benefits conferred, but according to the ability, or faculty, to pay. There have been three criterions of faculty: wealth, expenditures and income. The faculty theory is the one currently accepted and gives the ethical basis of the income-tax laws especially.

While the faculty theory is regarded as of more recent application, nevertheless its principle is old. Reference to such a basis is made in the "Laws of Manu," Manu being a divine character in

Hindu mythology. This code, which is said to be the highest authority in Indian law courts today, was probably written around the twelfth century B. C. Manu's maxim was, in part, ". . . to make the burden of taxes equal, it should be made to press with equal severity upon every individual. This is not effected by a mere numerical proportion. The man who is taxed to the amount of one tenth . . . of an income of 100 rupees per annum, is taxed far more severely than the man who is taxed an equal proportion of an income of 1,000 rupees." In other words, taxes, to be equitable, should be proportional to the faculty, or ability, to pay.

We next come to the consideration of the principles, or canons as they are called, of a good tax measure. There has been very little improvement on the canons which Adam Smith enunciated in his *Wealth of Nations*, published in 1776. These canons are: (1) equality; that is, the subjects of every state should contribute toward the government as nearly as possible in proportion to their respective abilities; (2) certainty, which means that the tax each individual is bound to pay should be certain and not arbitrary; (3) convenience; every tax ought to be levied at the time or in the manner which is most convenient for the contributor; and (4) economy; that is, the cost, etc., of collecting the revenue should not be large. Add to these one more maxim—elasticity, or the quality of being able to yield large revenues with slight basic changes—and you have what are today considered to be the main canons of taxation.

Another feature of taxation which has caused considerable controversy is direct versus indirect taxation. Without going into the controversy at all, and without attempting to portray the earlier meaning of these terms, suffice it to say that direct taxes are those which are levied with the intention of having them borne by the contributors, whereas indirect taxes are those that are levied in the belief that they will be shifted. Income taxes and property taxes are direct; customs duties and excise taxes indirect.

Taxes are either proportional, progressive or regressive. If the rate is stationary, the tax is proportional; if the rate increases with the increase in wealth, income or other faculty, the tax is progressive; and if the rate decreases with increases in the faculty, the tax is regressive.

Finally, we come to the incidence of taxation, or, in other words, who ultimately pays any tax. This, too, is a moot question and involves severe economic reasoning. We all know that some taxes are shifted, but which are shifted and how much and to whom are questions the answers to which are not within the scope of this paper. It might be said, in passing, that the income taxes are generally borne by the contributors and the excise taxes borne by the consumers, but further than this it is not safe to go.

Thus, to summarize, the chief economic aspects of taxation are five in number: the theories of justification (benefit and faculty); the canons of a good tax measure (equality, certainty, convenience, economy and elasticity); proportional, progressive or regressive taxation; the direct versus the indirect tax; and the incidence of taxation.

II

We now turn to the historical aspects of taxation. In the earliest times there was, of course, no taxation. Each individual was a sovereign unto himself—there was no state and, therefore, no need for public revenue. With the development of individualism into a social order states came into existence and with the states came some sort of public expenditure. The needs of the first states were probably supplied by contributions of labor and later by contributions of labor and property. When states went to war in such a condition of society, the soldiery fitted out themselves and depended upon plunder to keep them going. We are told that the great Socrates, because of the condition of his purse, went to war with poor accoutrements, but that he returned as well equipped as any.

Tribute collected from conquered peoples furnished a large part of the public income of successful states in the B. C. era and slaves performed the public labor.

With the development of commerce, coinage came into existence and the right of coinage provided the sovereign with revenue. Then we have escheat, the reversion of property to the crown, confiscation of property for various causes and the right to wrecks, as means of increasing the public purse.

We know that both Athens and Rome had property taxes before the end of their cultured and glorious days, but during the so-called dark ages this method of deriving revenue apparently was not employed.

In feudal times, no genuine tax systems were in effect. In legal theory the lands belonged to the king, but they were in the possession of feudal lords and we know that only a small part of the produce of lands was enjoyed by the vassals. The vassals, as a condition to their land tenure, also owed military service to their lieges so that between the produce of land and military service of his knights and their vassals, the king was enabled to meet the expense of his office. When the nature of the economic fabric of feudal times is understood, it can readily be seen that direct and indirect taxation would have been of no avail for there was, broadly speaking, no private property. However, the king had certain aids which helped fill his coffers. Stephen Dowell says the rolls of the exchequer show the following revenues to have been collected: "Robert Bardolph fines for pardon of the king's ill-will in the matter of the daughter of Geldewin de Doll. The Bishop of Winchester owes a tonnel of good wine for not reminding the king about a girdle for the Countess of Albemarle. Robert de Vaux fines in five of the best palfreys that the king would hold his tongue about the wife of Henry Pinel."

With the breaking up of the feudal system and the emergence of monarchical governments, numerous fees and charges were inaugurated and then, as governments became more firmly established and the right to tax was conceded by the taxed, indirect and, later, direct taxation came into prominent use. Direct taxation was the last method tried. From the earliest times, it was considered a disgrace for freemen to be taxed directly and it has taken centuries for direct taxation to overcome this prejudice. Direct taxation seems to have advanced as governments became more democratic and the explanation of this probably lies in the fact that in democracies the individual is directly concerned with the conduct of government and therefore feels an ethical obligation to support the government directly.

The development of the direct-tax systems culminated in the greatest of all tax schemes—the scheme with which we are all familiar—the income tax. A great many of us like to think of the income-tax scheme as of comparatively recent origin, but a little delving into the history of taxation shows this conclusion to be totally untenable. The date of the first income-tax law will probably never be determined to the satisfaction of all. Some writers say income taxes were collected in the B. C. period, but a study of some of the references discloses the taxes to have been on gross, instead of net, income, particularly taxes in kind, such as the tithes. According to Professor Seligman, the first income-tax law was adopted by the Florentines in 1451, 41 years before Columbus sailed from Palos. This was a straight percentage tax at first, but later a graduated or progressive tax.

The real precursor of our own income-tax statutes, however, was the act passed by England in 1799. Some of the provisions of that act justify consideration. Incomes of less than £60 were exempt; incomes from £60 to £200 were subject to progressive rates beginning with five sixths of one per cent. and incomes over £200 were subject to a straight tax of 10 per cent. Income of residents of England was taxed regardless of its geographic source and income from securities issued by the sovereign government was nontaxable. Returns were required from all taxpayers. Merchants filed their returns with "commercial commissioners" who were reputed skilled in determining the income of such taxpayers. Thus the modern revenue agent is not a new creature, or monster, if you prefer, after all. Regulations, too, were issued, under the pretentious caption of "A plain short, and easy Description of the different clauses of the Income Tax so as to render it familiar to the meanest capacity." How badly the writer of these regulations was needed in 1917! Credits were allowed for children, the amount of the credit varying with the size of the income. The tax was payable in instalments. The return, like the returns we know today, listed first the items of income and then the items of deduction. The yield for 1799 was a little more than £6,000,000.

Passing over the attempts of other European countries to use an income tax, omitting a discussion of the faculty taxes of the colonies, which some have confused with income taxes, and leaving out of consideration the state income tax-laws in the first half of the nineteenth century (including the income-tax law of Maryland in 1841) we come to the first federal income-tax statute. The first income-tax law passed by the federal government was in August of 1861, but this was amended before going into effect by the law of 1862. The act of 1862 was amended almost every year until 1870 and ceased to be a law in 1872. The tax was levied on individuals alone, separate taxes being levied against corporations. The rates varied in different years. Part of the time incomes from $600 to $5,000 were taxed at 5 per cent. while those over $5,000 were taxed at 10 per cent. Profit on the sale of real estate purchased more than two years previous was considered to be a capital transaction which resulted in no taxable income, under at least one of the acts. Depreciation apparently was not allowed.

The returns were not secret and in 1865 the taxpayers and their respective taxes were published by many of the leading newspapers. This feature provoked a discussion similar to that we experienced a few years ago when the publicity feature was in effect.

In 1894 another income-tax statute was passed. This tax applied to corporations as well as individuals and provided, inter alia, a 2 per cent. tax on individual incomes in excess of $4,000. The constitutionality of this law was tested in court, with the taxpayers' side represented by a grand array of celebrated counsel. The supreme court handed down a decision, by a five-to-four vote, that the tax was a direct tax and therefore unconstitutional. It will be recalled that paragraph 4 of section 9 of article I of the constitution provides that "No capitation, or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken."

In 1909 congress passed a joint resolution providing for the sixteenth amendment (the income-tax amendment) to the constitution. The amendment was ratified on February 28, 1913, thus giving rise to that horde of cases involving valuations, etc., as of March 1, 1913. The rest is very modern history—contemporaneous history. We know that an excise tax was levied on corporations in 1909, that income-tax laws were passed in 1913, 1916, 1917, 1919—the others are so well known that I will not run the risk of mentioning them.

A word about the revenues yielded by the different acts. The largest amount yielded by the Civil War acts in any single year was in 1866 when $73,000,000 (round figures) was collected. In the fiscal year 1914, $60,700,000 was collected; 1916, $124,900,000; 1917, $359,700,000; 1918, $2,800,000,000; 1919, $2,600,000,000; 1920, $3,900,000,000; 1921, $3,200,000,000; 1926, $1,900,000,000; 1927, $2,200,000,000.

Thus the famous "billion dollar congress" of 1890 (the first congress to appropriate a billion dollars) is shadowed into insignificance. Wars, of course, take their heavy toll of taxes. It was probably a study of war revenues that led Southey to write:

"Satan gave thereat his tail
 A twirl of admiration;
For he thought of his daughter War
 And her suckling babe Taxation."

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EDITORIAL

The Plural Prerogative

An accountant practising individually has written to ask for an expression of opinion as to the propriety of the use of the plural personal pronoun in his certificates, correspondence, etc. He wishes to know whether it is proper for him to describe himself as "we" or as "I." Well, that is largely a matter of opinion. There may be some occult reason for describing oneself as two or more, but it is not easily discovered. What might be called the plural singular is generally acknowledged to be an attribute of royalty and the editorial function. Editors and kings speak in a sense from the fane and no one may reply, at least immediately. For some reason, which no one can quite explain, these two classes of men have assumed the right to speak as though they were more than they are. Perhaps royalty in the use of the plural labors under the impression that what the monarch says is the voice of the people and, therefore, it is not one who speaks, but a multitude. Parenthetically it may be said that the multitude might not agree with this theory, but it is only lately that the multitude has counted for anything. Editors have always been free from any taint of diffidence, and the use of the plural in their case is intended to convey to the gullible public the impression that when the editor speaks he speaks with the voice of all the editorial office with him. Indeed, it used to be so. There was a time in the golden age of journalism when a group of men would gather to discuss the questions of the day, present their individual views and, after an agreement as to the policy to be expressed, would delegate one of their number to write the opinion of the court. This practice still prevails in a few offices. There is a powerful weekly publication in Great Britain whose opinions are only expressed after prolonged conference and a careful weighing of the arguments for and against. The conferences which culminate in the final editorial notes are delightful and generally inspiring. One who has been privileged to attend the luncheons at which the discussions take place will not readily forget the blended solemnity and gaiety which characterize the whole debate, and one feels instinctively that when the opinions are expressed they justify the use of the plural pronoun.

The Accountant Is Different

But an accountant is neither king nor editor. When he speaks in the plural he tells the world that he and his partners are speaking. If he has no partners, is he not guilty of double dealing—in a double sense? Sometimes when an editor writes in the plural he may know in his own mind that his voice is less than the voice of one. He may be not even expressing his personal opinion, but merely what he thinks someone else should think. When an accountant adopts plurality—or should we say duplicity?—he may deceive himself, but he does not deceive the public. How ridiculous it seems for one young, possibly able, but certainly impecunious person to write oracularly "In our opinion." A blunt and unkind citizen might remark that the use of the pronoun "we" in some cases seems to be merely a condensed "wee"—an adjective. But really, why should one pretend to be two people? Is not one person good? Why then attempt a factitious plurality? It may not be precisely apropos, but it certainly has a bearing upon the case to quote the first rule of professional conduct adopted by the American Institute of Accountants:

> "A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as 'Members of the American Institute of Accountants,' but a firm or partnership, all the individual members of which are not members of the Institute (or in part members and in part associates), or an individual practising under a style denoting a partnership when in fact there be no partner or partners or a corporation or an individual or individuals practising under a style denoting a corporate organization shall not use the designation 'Members (or Associates) of the American Institute of Accountants."

It will be noted in the foregoing quotation that a person practising under a style denoting a partnership, when in fact there be no partner or partners, may not describe himself as members of the Institute. This rule seems by inference to condemn what we have called the plural singular. No sane man is deceived by plurals. Everyone remembers the old story of the editor of the *Skippereen Eagle* who said, "We are now about to give Bismarck hell." How the iron chancellor must have quaked in his shiny boots to hear that awful "we"—if he happened to hear it. Of course, if X and Y are in partnership they must not speak jointly in the singular. It is perhaps rather a pity that we lack a distinctive dual number such as added to our distress in the Greek hours at school. Sometimes English seems distinctly inferior and ill-furnished. But X or Y by himself can look only absurd when he tries to be more than he is. Furthermore, the plural, when there be in truth singular only, is deceptive in intent. It is only a monarch or an editor who may arrogate to himself multiplicity of personality—

If I were a king or an editor,
I'd be what I am, but I'd sound like more.

Verification of Inventories

There is no subject at present before the accounting profession which receives more consideration than the accountant's duty and responsibility with reference to verification of the count and valuation of merchandise inventories. We have discussed the question editorially in this magazine; every periodical published which has the slightest interest in accountancy and some which have not devote space from time to time to a discussion of this question; nearly every meeting of accountants finds reference to inventory somewhere on its programme. The increasing interest in the topic is doubtless due to the growing opinion that unless the accountant is awake and aware he may be brought gradually into a position which he can not occupy with honesty and credit. We believe, of course, that the accountant should go as far as he can go in the verification of inventory figures, but there are clients and bankers who would place upon the shoulders of the accountant the full burden of responsibility for absolute accuracy in the records of quantity and quality of inventory. This question was discussed in the December issue of THE JOURNAL OF ACCOUNTANCY by Maurice E. Peloubet and his remarks have been quoted in many subsequent discussions. Among the letters which have been received in this office is one from Henry D. Love, a member of the Institute in Massachusetts. Upon receipt of Mr. Love's letter we forwarded it to Mr. Peloubet with a request that he reply, and we have now received permission to publish the correspondence as a contribution to the current literature on the subject of inventories. Mr. Love writes:

"I have read with interest the reprint in the December number of THE JOURNAL OF ACCOUNTANCY of the address delivered at a meeting of the New York State Society of Certified Public Accountants, New York, October 23, 1928, by Mr. Maurice E. Peloubet on inventories and the auditor.

"Reference is made to the first sentence of paragraph 2 of the reprint appearing on page 425 of the JOURNAL which says: 'To sum up, accountants should and can, in all but the most exceptional cases, take full responsibility for their inventory verifications in the same way and to the same extent as they do for any other balance-sheet item.'

"This is an interesting assertion, which, if true, can have only one construction; namely, that total inventory (not alone the verified figures of the controlling account on the general ledger) must be ascertained to be actually on hand precisely the same as the actual count of cash and securities must be made to prove that each of these assets is actually on hand at the date of audit, as called for by the verified controlling general ledger accounts.

"For the purposes of most clients, an audit is expected to show only two things; namely, 'How much does the client owe?' and 'What has he got?' The coveted certificate usually means that (and little else) to the client, and certainly means just that to any interested 'third persons' to whom the client exhibits his 'certified balance-sheet.'

"Consequently, it follows, logically, that no certificate, qualified or otherwise, should be attached to any balance-sheet unless, and until, the accountant has put himself and his work in the position of being able and willing to go on the witness stand to testify, under oath, that the assets called for by the balance-sheet were all actually seen to be on hand, and were the client's property in good title on the date of the audit.

"The question does not appear to be the 'accountant's responsibility for inventories'; but, apparently should be stated as 'the accountant's responsibility for a certificate (if any) that means exactly what it purports to say, both in law and equity.'

"I would not insult any accountant by thinking, let alone arguing, that anyone would issue a certificate of any kind for a balance-sheet showing cash and securities, unless, and until, said accountant had actually counted all of both these assets, and found them to be all on hand and in good title to the client, as demanded by the controls. Consequently, I do not see how any accountant may ignore this fundamental duty to any or all other assets. If difficulties, insurmountable, present themselves so as to prohibit proper count and on hand verification, except only by an 'ideal accountant' or clairvoyant (of which the supply is notably short at present) what is the use of all this discussion about obvious duty?

"We all know that such situations present themselves. The only thing to do, then, in all conscience, is to withhold any 'certificate, 'and write a comprehensive 'report' on the case, stating all of the facts of exactly what was done, and the conditions which forbade the issuance of any certificate, qualified or otherwise."

In his reply Mr. Peloubet says:

"Perhaps the thought behind the paragraph to which you refer might be made clearer when it is looked on as a plea, not for an extended physical verification of the items composing the inventory, but for a careful and intelligent utilization of the means which the accountant has at hand in the books and records themselves or through the agency of responsible third parties for the verification of the inventory.

"I am not quite clear as to the relevance of your point on cash and securities. I see how it might apply to a bank audit but my own experience is that in most audits the cash represented by that figure in the balance-sheet is not counted and could not be counted as it is merely a book account with the bank, the verification being made by comparison of the clients' records with certificates given by the bank. All we know in such a case is that the bank acknowledges the indebtedness payable on demand to the client. So far as securities are concerned it is not infrequent and is, I think, considered equally good auditing practice to verify these by certificate from the responsible custodians who hold them as it is to make a physical count where they are held in the company's own treasury or safe-deposit box. There are many other items which good auditing practice does not require should actually be seen. Few auditors, I think, go through a factory and by examination attempt to determine which machines were added during the year and which discarded and in that manner prove the additions and dismantlements shown by the records. The values represented by many other items are quite intangible yet may properly appear on the balance-sheet. Such items as various sorts of development and experimental work may be of substantial value in future years but may have no physical or tangible representation whatever. Goodwill, of course, is another item which, while admittedly present and valuable in many cases, can not be seen nor can title be verified.

"However, good accounting and auditing practice does not, I think, debar the auditor from giving an unqualified certificate to a balance-sheet containing some or all of these items.

"My endeavor throughout the whole article is to show that the inventory can be verified to about the same extent and by about the same means as would be applied to any other items appearing on the balance-sheet. In the first place inventories in whole or in part often are not on hand or within the physical control of the client at all. These, of course, are satisfactorily verified by warehouse receipts, bills of lading or other types of approved documents from third parties. The sentence following that which you quote in your letter reads: 'They should do this by means of the accounts and other records of the company with the additional corroboration of outsiders who can verify any parts of the inventory.' In the earlier part of the article various means of verification from the records are described and others are referred to. An attempt is also made to show the difficulties and unreliability of a physical count.

"I do not think it possible for an accountant to certify as the fifth paragraph of your letter would imply. The usual certificate 'presents a true and correct view of the financial position of the company' or shows 'the financial condition of the company' at a particular date. It is doubtful whether the public, the banks or the various stock exchanges require or wish more than this. To make a statement under oath that each individual item in the accounts is absolutely and undeniably correct in itself might be desirable if it were humanly possible, but even then the time and expense of producing it would be in most cases prohibitive and that it would have any advantages over the present form of statement is questionable. It certainly is not a requisite to a true presentation of the financial position and condition of a company and of its operations during a period.

"I am glad you brought up these points and trust this will make clear my personal view that accountants should approach the inventory question from the accountant's viewpoint—not from that of the appraiser.

"It is a great pleasure to read letters such as yours as they indicate that the subject is timely and that there is some interest taken in it from the point of view of principle and theory as well as from a strictly practical point of view."

The whole subject of inventories is so vitally important that its discussion should not end here. Everything that can be said or done to indicate the clear line of demarkation between what an accountant may do and may not do is needed. Further correspondence will be welcome.

The Menace of Fee-Splitting

A brief note in the daily papers recently reported that the new president of the New York Academy of Medicine had said that fee-splitting among the members of the medical profession has grown to such proportions that it threatens to lead "to disaster, if not disgrace." The speech in full has not yet appeared in print and it is not absolutely clear what the speaker had in mind. Possibly the reference is to the paying of commissions to apothecaries, hotel clerks, dentists and others who make recommendations. Perhaps the speaker referred to cutting fees in order to attract the patients of other physicians. Perhaps he was thinking of physicians who go shopping among surgeons before referring cases to them. But for the present argument it does not matter in the least what was the iniquity to which the speaker referred. The important point is that one of the oldest, and certainly one of the most noble, professions is being threatened by the growth of unprofessional competition. If there were no rivalry between members of the medical profession there would be no fee-splitting or fee-cutting. There has always been a spirit of emulation in the profession and it may be that there has always been competition, but it is something new to hear a prominent member of the profession utter words of warning against the threat of "disaster, if not disgrace." Evidently the danger which confronts the practice of medicine and surgery is real enough to call for admonition. If splitting fees or cutting fees, whichever it may be, is so prevalent that the recent monitory utterance is deserved, the profession must have fallen on evil days. And herein is a lesson for other professions. Medicine is perhaps the most firmly founded of all. Its history runs back into the mists; its practice is ubiquitous; its value to the world is incalculable; its record of high professional morale is unsurpassed. If unethical practices can imperil a profession so ancient and so established what irreparable injury might they not do in accountancy which has only lately taken its seat in the senate of the professions?

Professions Are Urged to Advertise

A Chicago journal, which modestly describes itself as the world's greatest newspaper, has been endeavoring to impress upon the medical profession the desirability of departing from that rule of ethics which forbids professional advertisement. It seems from the statements which have appeared that members of the medical profession are "sympathetic to the proposal" that physicians and surgeons should be allowed to advertise. The following paragraphs are typical:

> "One of the most frequent criticisms of the present restriction against advertising is that a number of physicians actually receive the full benefits of advertising through prominent mention in the news columns. Without violating the ethics of the profession they have the faculty of gaining publicity concerning their work or their statements. This the critics who have expressed themselves consider an injustice, for the equally competent practitioner or specialist lacking this front page flair must be content with obscurity. He can not overcome his disadvantage by making a dignified statement of his professional preparation, his specialty, his hours of consultation, and his associations through an advertising medium.
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> "Others have suggested that the advertising prohibition is a superannuated convention, a static influence limiting the practice of physicians without self-promotion ability and denying information to the public. In cities, particularly where there is little neighborhood stability, a doctor is handicapped. He can not depend upon a reputation to bring him patients because of the shifting population and he is restrained from fixing the attention of the community upon his practice by the insertion of a professional card. The public, too, without the institution of the family doctor is without medical advice in emergencies. Consequently there is the likelihood of a patient becoming the victim of unscrupulous practitioners or of a cult.
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> "It is the influence of the American Medical Association, of course, which prevents such a revision of medical ethics. It is responsible, as no other agency could be, for the high medical standards, progress in medical research, distribution of information, and promotion of the public health in this country, but with its power there is the danger of creating too great censorship, of resisting progress with the inertia of tradition. It is well known that a number of its members regard its control of the profession as tyrannous. Some of this criticism should not be entirely discredited, although sympathy for the quacks who have been outlawed by the association and whose practice is constantly being fought should decidedly not be encouraged. In some respects the restraints imposed upon amateurs by the American Lawn Tennis association are comparable to the censorship of the American Medical Association. In forbidding amateurs to engage in certain publicity activity the tennis association refused to refashion its rules according to changing conditions. The same observation is probably somewhat justified in the case of the American Medical Association."

We do not believe that the American Medical Association is going to be greatly affected one way or the other by the editorial efforts of the world's greatest newspaper. The profession is too vertebrate for that, but some of the arguments which are contained in the matter which we have quoted have a familiar ring. We seem to have heard them in other days from other sources. For example, "He can not overcome his disadvantage by making a dignified statement of his professional preparation, his specialty, his hours of consultation, and his associations through an advertising medium." It is a pity, is it not? He should be allowed to say in large type, "Dr. John Doe, graduate of Such-and-Such University, having achieved notoriety by virtue of scholastic attainments, offers his services to the sick public. His experience in the treatment of imaginary ailments qualifies him to prescribe those therapeutic drugs which will conduce to the peace and satisfaction of the patient. He specializes in the care of old and wealthy dowagers and nervous young mothers. Those who depend upon his services will get what they deserve." Perhaps that is not a dignified statement, but it is the kind of statement that would be made by many young practitioners if they were truthful. How utterly ridiculous the whole argument is. If physicians and surgeons are to advertise their qualifications what chance will the young practitioner have? The very men whose names are known throughout the country will be those who will receive the great benefit. Men who have done nothing noteworthy will have nothing to advertise and their position will be rendered untenable. Abstinence from advertising is really the safeguard of the novice. We are quite ready to admit that the newspaper which has been agitating this question is animated by the most lofty motives. It is not seeking to bring advertising revenue into its coffers. It is merely endeavoring to protect an oppressed and afflicted minority of the medical profession. From time to time other papers will attempt to come to the relief of the downtrodden accountant and will put forth arguments of the same general sort. But still we shall come back to the old and unanswerable argument that if there is to be advertising it will simply verify the inspired adage: "For whosoever hath, to him shall be given, and he shall have more abundance; but whosoever hath not, from him shall be taken away even that he hath"

The Sin of Conservatism

A writer in the *Wall Street Journal* recently complained of that conservatism of some corporation directors which induces them to hide assets and earnings, either to increase the strength and scope of the company by ploughing in surplus funds or to accumulate reserves from which dividends may continue to be paid if less affluent times are encountered in the future. While such a policy may protect the permanent investor, one may not deny that nowadays the permanent investor is in the minority. The most retentive stockholder is usually quite willing to sell his shares if he is persuaded that by the sale he will realize a substantial profit or avoid an imminent loss. Of course accountants agree that there is no justification for any policy which results in a material misstatement of financial condition. The public, however, has been inclined to vent all its indignation on companies which indulged in overstatement, without fully recognizing the almost equally evil practice of understatement. The worst feature of secrecy in matters of corporate finance is that the facts are not concealed from everyone alike. Certain stockholders, who happen also to be directors, and certain employees of the company who may not even be stockholders know the true situation at all times. The understatement of assets or earnings, or both, in published reports does not influence these "insiders" but deprives the larger number of stockholders of information to which they have an inherent moral and legal right. This sort of ultra-conservatism, therefore, is apt to foster a suspicion that those responsible for it may be deriving advantage at the expense of other owners of the company. The writer in the *Wall Street Journal,* while he deplores bureaucracy, hints that statutory insistence on complete and truthful financial reports may be the result if offending corporations do not themselves recognize the necessity for reform. It would be a pity to aggravate the legislative burden of business, but paternalism is the just reward of indifference.

A Statutory Audit?

If laws were passed to insure the issuance of wholly satisfactory financial reports the situation would be somewhat akin to that in England under the companies' acts. Perhaps corporations would be compelled to engage independent auditors to report periodically to stockholders and to government officers. In some states certain kinds of companies are now required to do this. Perhaps some official mechanism would be created under governmental supervision, whereby state employees would investigate the financial condition of all corporations, after the manner of bank examiners. Probably each state would deal with the problem in a different way, and the resultant confusion and annoyance to interstate business can not easily be imagined. American accountants have always championed the cause of business in opposition to excessive interference by government authorities, and they would not be inclined to change their position merely because their practice might be augmented by a paternalistic innovation. The desirability of a statutory audit in a country where uniformity of requirements is impossible is very doubtful. However, there is no immediate indication that the law will have to be invoked in order to show reactionary directors the error of their ways. Most corporations of importance now voluntarily avail themselves of the services of independent auditors, and the reports of accredited accountants are willingly accepted by stockholders, bankers and government officers. Public opinion, supported by gradual education, will doubtless induce eventual unanimity on the question of the independent audit and will solve the problem. Complete and correct financial information, with a policy of frank publicity, has always been advocated by American accountants. Professional conservatism, which provides the margin of safety that makes the reports of reputable accountants absolutely trustworthy, will never countenance the ultra-conservatism which would withhold from those fully entitled to it information even remotely affecting their interests.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON TERMINOLOGY OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The special committee on terminology submits the following tentative definitions for consideration and criticism. Comments from readers will be welcome. Letters may be addressed to the committee in care of THE JOURNAL OF ACCOUNTANCY.

CORPORATION—ELEEMOSYNARY:

In general, a corporation organized, not for profit but for the purpose of giving assistance to those in need thereof. Perhaps the most general example in this country is a free hospital.

In particular, Blackstone defines such organizations as corporations constituted for the perpetual distribution of the free alms, or bounty, of the founder of them to such persons as he has directed.

CORPORATION—MUNICIPAL:

Towns and cities in the United States act under certificates of incorporation issued under the laws of the several states. These are municipal corporations.

CORPORATION—PERSONAL-SERVICE:

Under the federal income-tax laws certain corporations are described as personal-service corporations. These are corporations not engaged in buying, selling or manufacturing merchandise, and not gaining their income from investment of money, but from personal services rendered by the officers and employees of the corporation. There may be some invested capital, but not so much that it is a major source of income. Income-tax laws, regulations and decisions set forth the limitations within which a corporation may be classed as a personal-service corporation.

CORPORATION—RELIGIOUS:

A corporation formed to promote some religious object or to own property devoted to religious uses.

CORPORATIONS—LAY:

Bodies politic; (1) civil for temporal purposes, and (2) eleemosynary for charitable purposes (Dawson).

COMPANY—PROPRIETARY:

Another name for "controlling company" or "parent company." A proprietary company is not an operating company (Munn).

CORPORATION—NON-STOCK MONEYED:

A savings bank, building-and-loan association, credit union, or related business engaged in some phase of banking and organized without shares of stock, the profits belonging to the depositors. Non-stock banking corporations are also known as mutual associations (Munn).

COMPANY—FINANCE:

A term used to denote several different types of institution. It is sometimes employed in this country to denote (1) a holding company, (2) a commercial credit company. In England the term usually refers to a company dealing in corporate securities (Munn).

CORPORATION—FINANCIAL:

The term includes banks, trust companies, insurance companies, building-and-loan associations and other similar corporations (Bienvenu).

CORPORATION—PUBLIC:

One created for the purpose of local government as, for example, a municipality.

COMPANY:

In addition to the terms already defined, both in this issue and in the JOURNAL for January, 1929, the following expressions are sometimes used in a more or less colloquial manner, the adjective in each case indicating the nature of the business in which the company is engaged. They are not established terms having a special technical meaning. Company—agricultural, industrial, indemnity, insurance, manufacturing, mining, mutual, securities, security, store, surety, trading.

CORPORATION:

In addition to the terms already defined, both in this issue and in the JOURNAL for January, 1929, the following expressions are sometimes used in a more or less colloquial manner, the adjective in each case indicating the nature of the business in which the corporation is engaged. They are not established terms having a special technical meaning. Corporation—commercial, membership, moneyed, public, system.

A correspondent asks for examples of a "revolving fund" as defined in the JOURNAL for September, 1928.

One of the examples most frequently encountered is a petty-cash fund kept on the imprest system, in which disbursements are made from time to time. When the fund becomes depleted the amount spent is replaced from a general fund and the actual cash on hand is restored to its original amount.

Another instance is found in revolving funds established to assist college students. In this case money is given to the fund and sums are lent to assist students. When these loans are repaid the money returns to the fund, which is thus kept constantly revolving.

There have been proposed farm-relief funds, whereby the government would set up a fund, lending money on crops, receiving the money back on sale of the crops, relending it, and so ad infinitum. This would be a revolving fund.

The committee is, perhaps, entitled to feel some pride or satisfaction in having received its first anonymous criticism. Usually such letters are undeserving of notice, but in this case the criticism appears to be honest and the point raised is interesting. The letter reads as follows:

> Permit me to disagree with your correspondent in the October issue of THE JOURNAL OF ACCOUNTANCY wherein he says that "the term 'cost

> of goods sold' is preferable to 'cost of sales.'" It seems to me that there is a very distinct difference in the use of these two terms.
>
> Cost of *goods* sold is the cost of raw materials, labor and manufacturing expenses, the actual purchase and manufacturing cost of the *goods* or merchandise sold, with due adjustments in the inventory, the ordinary form of manufacturing account, or in the case of a trading concern the purchase cost of the merchandise sold.
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> Cost of sales is applicable only to industries where no *goods* or merchandise is bought for sale, and where the profits are from sources other than sales in the ordinary sense of the word, such as dyeing establishments, laundries, garages, automobile-repairs shops and similar quasi-service businesses. Cost of sales in my opinion is substantially the same as production cost and should be used in the profit-and-loss statement to show the cost of production in non-manufacturing or trading concerns.

The committee feels that there is some ground for this criticism. When considering the definitions referred to, it had more particularly in mind the manufacturer and the merchant, and may have failed to give sufficient consideration to what the treasury department has taught us to call personal-service enterprises.

The committee has no desire or intention to hedge; it adheres to its definitions as being proper in the classes mentioned above but is willing to add a paragraph to the definition of "Cost of goods sold," as follows:

> In businesses where services rendered constitute the principal basis of charges to customers, such as laundries, cleaners, garages and undertakers, in which it is not unusual to speak of the transactions as "sales," the use of the expression "Cost of sales" is preferable.

The committee has received the following inquiry:

> With the object in view of adopting progressive terminology in our reports and conforming to the best accounting practice at present, we are anxious to obtain an expression from your committee concerning the following items. Both the usual technical designations and the various designations which have occurred to us are given.

Statement or account	*Terminology*
1. Balance-sheet	(a) Balance-sheet
	(b) Statement of assets, liabilities and capital
2. Profit-and-loss statement	(a) Profit-and-loss account
	(b) Profit-and-loss statement
	(c) Statement of operations
3. Accounts receivable	(a) Trade debtors
	(b) Customers' accounts receivable
	(c) Accounts receivable
4. Reserve for bad debts	(a) Provision for bad debts
	(b) Allowance for bad debts
	(c) Reserve for bad debts
5. Reserve for depreciation	(a) Provision for depreciation
	(b) Allowance for depreciation
	(c) Reserve for depreciation.

Most of the questions raised have been dealt with by the committee, but the members are glad to reply and to express their views.

1. *BALANCE-SHEET:*

(a) This was defined at some length in the JOURNAL for August, 1923, as a statement prepared from books kept by double entry. The committee is of the opinion that its use should be restricted to such statements.

(b) Statement of assets, liabilities and capital is similar to a statement of financial condition, defined in January, 1928. It may be prepared from books kept on the single-entry system or from other sources, and inasmuch as it lacks the support behind a balance-sheet, it should be verified even more carefully than the more formal statement.

2. *PROFIT-AND-LOSS STATEMENT:*

(a) The profit-and-loss account is, strictly speaking, the account which is written in the ledger, and is frequently changed in its arrangement when presented as a formal statement. The use of the term should be so limited.

(b) "Profit-and-loss statement" is a proper description. A detailed definition appeared in the JOURNAL for September, 1923.

(c) Statement of operations is similar to an operating statement, defined in the JOURNAL for January, 1928, and constitutes one portion of a profit-and-loss statement.

The committee recommends the use of the expression "Profit-and-loss statement" or "Statement of the profit-and-loss account."

3. *ACCOUNTS RECEIVABLE:*

(a) "Trade debtors" is too broad an expression if used by itself, for it may include debtors who owe on open account, either secured or unsecured, or notes receivable, each of which items should be shown separately.

(b) and (c) Customers' accounts receivable and accounts receivable are proper terms, either of which may be used, depending upon the nature of the business, the former being the wording suggested in the federal reserve bulletin on a uniform balance-sheet. Some accountants add the word "trade" (usually in brackets) to emphasize the fact that the assets arise through current business and are not in the nature of advances, which should appear separately.

4. *RESERVE FOR BAD DEBTS:*

(a) Provision for bad debts, (b) Allowance for bad debts, (c) Reserve for bad debts. A definition of "allowance" appeared in the JOURNAL for October, 1922, and the committee then expressed its opinion that the use of the term "allowance" as synonymous with "reserve" or "provision" should be discouraged.

A further definition of "allowance" appeared in the JOURNAL for August, 1928.

"Provision" and "reserve" were defined at length in the JOURNAL for October, 1922, and the committee, while leaning towards a preference for "Provision for bad debts," feels that no adverse criticism could be made against the term "Reserve for bad debts."

The term "provision" may well be used also for an amount set up to cover liabilities known to exist, although the exact amount will not be ascertained until a future date, or for disputed liabilities arising out of past transactions.

5. *RESERVE FOR DEPRECIATION:*

(a) Provision for depreciation, (b) Allowance for depreciation, (c) Reserve for depreciation. The committee believes that in this case the expression "Reserve for depreciation" is so generally used and understood by bankers, the business world and accountants that its use should be continued.

Income-tax Department

EDITED BY STEPHEN G. RUSK

The United States circuit court of appeals, in reviewing a case previously tried by the board of tax appeals, rendered a decision which seems to be of major importance, in the case of *The Kendrick Coal Company* v. *Commissioner*.

In the language of the laity, and excluding any technical points, the court held that while the circuit court of appeals could not enlarge or piece out the findings of fact of a fact-finding body (such as the United States board of tax appeals) it could look to the facts upon which the decision was made to inform itself as to whether or not the facts justified the adjudication.

In the case of the Kendrick Coal Company, the court held that:

> "The order of the board of tax appeals is not sustained by its findings of facts, there being no findings as to (a) the cost of assets transferred by the corporation, and (b) the value of such stocks received in exchange . . ."

The court thereupon reversed order of the board of tax appeals and remanded the case with instructions to the board for such "further proceedings as may be deemed advisable not inconsistent with the views of the court."

The views of the court, as set forth above, seem especially appropriate, for in reading decisions of the board we have frequently observed appeals wherein the findings of fact seemed to bear no relation to the decision made—in fact, the decision seemed to be exactly contrary to that which might be expected from the findings of fact.

Other tax practitioners must have noted this wide divergence between facts and opinions, and have been puzzled by the apparent anomaly.

Another decision of more than passing interest is that of the *Broadway Savings & Trust Company* v. *United States*. In this case the United States court of claims held that even though it was stipulated that a certificate representing a bond of a corporation going through receivership was charged off by a bank upon the recommendation of the Clearing House Association, supplemented by an independent investigation by the taxpayer, it was not established that such debt was ascertained to be worthless. The aforementioned debt was charged off in 1919, and the deduction was therefore made under the provisions of the act of 1918. Bearing upon this subject is section 214 (a) (7), of the act of 1918, which reads, in part, as follows:

> "That in computing net income there shall be allowed as deductions: debts ascertained to be worthless and charged off within the taxable year; . . . ."

It is difficult for a layman to understand just what procedure should be used to ascertain that a debt is uncollectable, and this decision befogs the taxpayer to a greater extent.

It appears that the representative of the Clearing House Association considered the bond of no value, for if he did not so consider it he could have recommended that some portion of the book value be charged off. Furthermore, it appears that the taxpayer satisfied himself by a personal investigation as to the accuracy of this opinion, and, therefore, "ascertained the debt to be worthless" to quite a satisfactory degree.

There is nothing in the language of the act to indicate that the commissioner or any court should determine the worthlessness of a debt. The entire responsibility seems to be upon the taxpayer, and it appears doubtful that the commissioner is authorized to interpose his opinion. It will be argued, of course, that the language was not intended to leave to the taxpayer's discretion, entirely, the ascertainment of the worthless character of the debt; but, one may ask, whose duty is it to charge off the bad debt in the books?

One of the prime necessities required by the 1918 act was that a bad debt should be "charged off" within the taxable year. It is assumed that the rather ambiguous phrase "charged off" refers to the bookkeeping process of charging to profit and loss and crediting an asset account. We have not yet heard of any outsider with authority to make entries in books of account without the consent of the one who owns the records. It would follow, therefore, if a taxpayer authorized an entry in which an asset was "charged off", that the taxpayer must have ascertained that the asset was worthless.

If, upon examination, the commissioner ascertained that the taxpayer's judgment was defective, he might properly be authorized to require that the "charge off" entry be reversed, after presenting some proof that the taxpayer's conclusion was erroneous. If an asset is of such character that a Clearing House Association's examiner deems it worthless, and the taxpayer himself, upon due investigation, arrives at the same opinion, it would seem that the contra opinion of a governmental officer should be scrutinized and should not be given as much evidential weight as that of those who differ with him.

If any injustice is done the federal government by an erroneous "charge off" of a bad debt, a remedy is prescribed in provisions of the act that debts previously charged off and subsequently collected shall be included in gross income of a taxpayer.

SUMMARY OF RECENT RULINGS

Section 274 (a), act of 1926, permitting injunction pending an inquiry before the board of tax appeals extends not only to the collection of a deficiency asserted by the commissioner which was appealed to the board, but also extends to any unpaid portion of the original assessment. (U. S. circuit court of appeals, fifth circuit, *Peerless Woolen Mills* v. *J. T. Ross, collector.*)

The decedent's gross estate should not include the corpus of a trust created in 1916 providing for the distribution of the income thereof, and, at his death, of the corpus to the settlor's issue, where the trust deed provided that the settlor, but only with the written consent of the trustee, might modify or revoke the trust, in whole or in part, and the settlor, by written deed with the consent of the trustee in 1919, rearranged the shares in the corpus within the group originally fixed, such power of revocation conditional on the consent of the trustee, not being a "general power of appointment exercised by the decedent" within the meaning of sec. 402 (a), act of 1918. (U. S. Circuit court of appeals, second circuit, *The Farmers Loan & Trust Co., trustee,* v. *Frank K. Bowers, collector.*)

Amount entered in 1920 on his books as income by a member of a partnership under an arrangement with another member, to which the other partners had never consented, which arrangement was disclaimed in 1921 and readjusting entries were thereupon made in that year on the taxpayer's books, should not be included in his gross income for 1920, such income in fact belonging to the partnership. (U. S. circuit court of appeals, fifth circuit, *J. L. Reinschmidt* v. *Commissioner.*)

The rule that an appellate court will not look to the opinion of a fact-finding court or body to eke out the findings of fact made by such court or body applies to the board of tax appeals. This court held that the order of the board of tax appeals in decision 2409 is not sustained by its findings of fact, there being no findings as to (a) the cost of assets transferred to a corporation, and (b) the value of such stock received in exchange, and the case was reversed and remanded with instructions for such further proceedings as may be deemed advisable not inconsistent with the views of the court. (U. S. circuit court of appeals, eighth circuit, *Kendrick Coal & Dock Co.* v. *Commissioner.*)

Annual payments for life which a widow elected to accept under the will of her deceased husband in lieu of her statutory interest in his estate under the Nebraska law, are not taxable income to her under the 1918, 1921 and 1924 acts until she shall have recovered the value of her interest in the estate, since by her election to take under a will she became a purchaser for value of the yearly payments. (U. S. circuit court of appeals, eighth circuit, *Arthur B. Allen, collector,* v. *Mrs. Arthur D. Brandeis.*)

The evidence as to the grounds for an addition to a bad-debt reserve deducted in 1921 by a taxpayer (which had set up a reserve in 1919) in addition to bad debts ascertained to be worthless and charged off, was held to be highly persuasive if not entirely conclusive. The order of the board of tax appeals in decision 2897, in which the board denied a deduction for an addition to a bad-debt reserve claimed in addition to debts ascertained to be worthless and charged off, and allowed a deduction for bad debts, was vacated and remanded with instructions to consider, legally and reasonably, claimed deductions of items consisting of a debt disallowed and the addition to the reserve claimed, as additions to the reserve allowable in whole or in part, in the sound discretion of the taxing authorities. (U. S. circuit court of appeals, first circuit, *Rhode Island Hospital Trust Co.* v. *Commissioner.*)

The court was unable to hold that there was no substantial evidence to sustain the finding of the board of tax appeals that the purchase of a residence was not a "transaction entered into for profit" resulting in no deductible loss upon sale thereof in 1921 where the taxpayer resided in the property up to the time of sale except for several short periods when he was absent from the country. (U. S. circuit court of appeals, first circuit, *Henry DeFord* v. *Commissioner.*)

A stipulation that a trust certificate representing a bond of a corporation going through a receivership was charged off by a bank in 1919 upon recommendation of an examiner of the Clearing House Association supplemented by independent investigation by the taxpayer, was held not to have established that such debt was ascertained to be worthless in that year. (U. S. court of claims, *The Broadway Savings Trust Co.* v. *United States.*)

An overpayment of taxes may not be refunded where no claim therefor was filed within the statutory period, and a claim for refund based upon the right to special assessment filed after the expiration of the statutory period under the applicable act, does not relate back to a claim for a refund for the same year, filed within the statutory period, which was not based on the grounds given in the later claim. (U. S. court of claims, *Jonesboro Grocer Co.* v. *United States.*)

A waiver on assessment of taxes for the fiscal year 1919 executed after the expiration of the statutory period on assessment is not valid to extend the period of assessment, the provisions of section 276 (c), act of 1924, relating only to an agreement entered into prior to the expiration of the statutory period. (Court of appeals of the District of Columbia, *Joy Floral Co.* v. *Commissioner.*)

A mutual life-insurance company's invested capital for 1917 includes the amount of the reserve funds maintained by it, as required by law, made up of premium payments paid in for insurance policies. (U. S. court of claims, *The Minnesota Life Insurance Co.* v. *United States.*)

A mutual life-insurance company's gross income for income and capital-stock purposes should not be reduced by the amount of the net additions to its deferred-dividend reserves which it was required to maintain by state statutes under the provisions of section 12 (a) (2), act of 1916, and section 234 (a) (10), act of 1918. (U. S. court of claims, *The Minnesota Mutual Life Insurance Co.* v. *United States.*)

The taxpayer has the burden of proving error in the commissioner's findings. The fact that the commissioner's answer to a petition before the board of tax appeals was not under oath did not result in a default or a shifting of the burden, the rules of the board governing practice and procedure, which it had the authority to prescribe, not requiring such verification. (U. S. circuit court of appeals, seventh circuit, *Sam Greengard* v. *Commissioner.*)

The board of tax appeals erred in holding that the evidence was insufficient for the determination to a newspaper of building up a circulation structure which admittedly should be restored to invested capital, such cost originally having been charged to expense. (Court of appeals of the District of Columbia, *News Publishing Co.* v. *Commissioner.*)

Waiver of collection of additional tax for 1917, assessed in 1920, executed in 1925, after statute of limitations had expired, was void for want of consideration running to the taxpayer. The waiver provided for extension of the six-year period for collection after assessment under sec. 278 (d), act of 1924, although collection was barred when such tax was passed. (U. S. district court, E. D. New York, *James A. Walsh* v. *Warren G. Price, collector.*)

The amount received by an inventor in 1920 as compensation for the transfer to his employer in 1911 of all of his interest in a certain patent application, did not constitute income to him for 1920, but was the "purchase price of capital sold in 1911" where at the time of the transfer, the inventor knew of a rule of his employer that a "sum of money" would be paid, the amount depending upon the circumstance, the patent not being finally issued until 1918 after litigation conducted by the employer. B. T. A. reversed. (U. S. circuit court of appeals, third circuit, *Augustus M. Saunders* v. *Commissioner.*)

Students' Department

H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

(Note.—The fact that these solutions appear in The Journal of Accountancy should not cause the reader to assume that they are the official solutions of the board of examiners. They represent merely the opinion of the editor of the *Students' Department.*)

Examination in Accounting Theory and Practice—Part I (*continued*)

November 15, 1928, 1 P. M. to 6 P. M.

The candidate must answer the first three questions and one other question.

No. 5 (27 points):

On a certain date, Mr. Mann borrowed $15,000. As he expects to inherit $5,000 three years from this date, he wishes to reduce the loan by $10,000 in the three years by making equal monthly payments, including interest at the rate of one half of one per cent. per month.

What would be the amount of the monthly payment?

Given v^{36} .8356449
$(1+i)^{36}$ 1.1966805

Solution:

That portion of the loan ($10,000) which Mr. Mann wishes to pay in three years in equal monthly instalments represents the present value of an annuity. The equal monthly instalments are the rents produced. Therefore:

1 − .8356449 = .1643551 compound discount

.1643551 ÷ .005 = 32.87102 present value of annuity of 1

$10,000.00 ÷ 32.87102 = $304.22 equal monthly instalments to reduce the loan by $10,000

In addition, the amount of simple interest on the remainder, $5,000 at .005 per month, or $25, must be included as a part of the monthly payment. The total is, therefore, $304.22 + $25.00 or $329.22.

This amount may be proved by setting up a table of reduction as follows:

Table of reduction

Month	Payment	Interest	Principal	Balance
				$15,000.00
1...........	$329.22	$75.00	$254.22	14,745.78
2...........	329.22	73.73	255.49	14,490.29
3...........	329.22	72.45	256.77	14,233.52
4...........	329.22	71.17	258.05	13,975.47
5...........	329.22	69.88	259.34	13,716.13
6...........	329.22	68.58	260.64	13,455.49
7...........	329.22	67.28	261.94	13,193.55
8...........	329.22	65.97	263.25	12,930.30
9...........	329.22	64.65	264.57	12,665.73
10...........	329.22	63.33	265.89	12,399.84
11...........	329.22	62.00	267.22	12,132.62
12...........	329.22	60.66	268.56	11,864.06
13...........	329.22	59.32	269.90	11,594.16
14...........	329.22	57.97	271.25	11,322.91
15...........	329.22	56.61	272.61	11,050.31
16...........	329.22	55.25	273.97	10,776.34
17...........	329.22	53.88	275.34	10,501.00

Month	Payment	Interest	Principal	Balance
18...........	$329.22	$52.51	$276.71	$10,224.29
19...........	329.22	51.12	278.10	9,946.14
20...........	329.22	49.73	279.49	9,666.65
21...........	329.22	48.33	280.89	9,385.76
22...........	329.22	46.93	282.29	9,103.47
23...........	329.22	45.52	283.70	8,819.77
24...........	329.22	44.10	285.12	8,534.65
25...........	329.22	42.67	286.55	8,248.10
26...........	329.22	41.24	287.98	7,960.12
27...........	329.22	39.80	289.42	7,670.70
28...........	329.22	38.35	290.87	7,379.83
29...........	329.22	36.90	292.32	7,087.51
30...........	329.22	35.44	293.78	6,793.73
31...........	329.22	33.97	295.25	6,498.48
32...........	329.22	32.49	296.73	6,201.75
33...........	329.22	31.01	298.21	5,903.54
34...........	329.22	29.52	299.70	5,603.84
35...........	329.22	28.02	301.20	5,302.64
36...........	329.22	26.54	302.68*	5,000.00
Paid from inheritance..	5,000.00	....	5,000.00	....
Total......	$16,851.92	$1,851.92	$15,000.00	

*Adjusted for 4-cent difference due to carrying out decimals to only two places.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

NOVEMBER 16, 1928, 1 P. M. TO 6 P M.

The candidate must answer the first three questions and two other questions.

No. 1 (25 points):

A company, engaged in the manufacture of piece goods, had no cost system. Its sales were made on the basis of estimated costs, adding 15 per cent. to estimated direct cost to cover overhead, then adding to the total so estimated a profit equal to 12 per cent. of the selling price.

At the end of the year 1927, the trial balance was as follows:

Buildings..	$276,000	
Machinery..	310,000	
Spools and other similar items..................	33,000	
Accounts receivable............................	110,000	
Accounts payable...............................		$27,000
Reserves for depreciation to Jan. 1, 1927—Buildings......................		36,000
Machinery......................		71,000
Sales..		2,013,000
Inventory—January 1, 1927.....................	157,000	
Purchases—raw material.........................	1,200,000	
Labor—direct....................................	480,000	
" foremen, etc.............................	213,000	
Office payroll..................................	76,000	
Factory expense................................	280,000	
Office and administration expenses..............	113,000	
Capital stock..................................		1,000,000
Cash in bank...................................	18,000	
Surplus—January 1, 1927.......................		119,000
	$3,266,000	$3,266,000

An estimated cost, which may be taken as representative of all the estimated costs, was as follows:

Cost per yard:

Raw material	$ .89
Weaving—piece-work	.38
Winding, warping, etc.	.03
Foremen and supervision	.10
	$1.40
Factory and office overhead—15% of $1.40	.21
	$1.61
Profit—12% of $1.83	.22
Selling price per yard	$1.83

Inventories were principally of raw material and for the present purpose may be considered as consisting entirely of raw material at cost. The inventory at December 31, 1927, was valued at $376,000.

The rate of depreciation on buildings was 2 per cent. and on machinery, 7½ per cent.; spools, etc., were not depreciated; replacements were charged to operations (factory expense).

Before the books were closed, it was realized that a heavy loss had been sustained. Suggestions were made—a defalcation, material stolen, etc.

What was the amount of the loss and to what do you ascribe it? Indicate briefly what is needed to prevent a repetition of such conditions.

Solution:

If the trial balance and the amount of the closing inventory are correct the loss for the year 1927 was $158,770 as shown in the following exhibits:

Exhibit 1

A COMPANY

Statement of cost of goods manufactured and sold
for the year ended December 31, 1927

Materials used:		
Inventory, January 1, 1927	$157,000	
Purchases	1,200,000	
Total	$1,357,000	
Inventory, December 31, 1927	376,000	
Materials used		$981,000
Direct labor		480,000
Foremen and supervision		213,000
Total "direct cost"		$1,674,000
Factory overhead:		
Factory expense	$280,000	
Depreciation—buildings (2% of $276,000)	5,520	
Depreciation—machinery (7½% of $310,000)	23,250	
Total factory overhead		308,770
Cost of goods manufactured and sold		$1,982,770

Exhibit 2

A COMPANY

Statement of profit and loss
for the year ended December 31, 1927

Sales		$2,013,000
Cost of sales (exhibit 1)		1,982,770
Gross profit		$30,230
Less: Expenses:		
Office payroll	$76,000	
Office and administrative expenses	113,000	
Total expenses		189,000
Loss for year		$158,770

The following comparison of estimated and actual unit costs is based on a production of 1,100,000 yards. The amount of the yardage was determined by dividing the amount of the sales, $2,013,000 by the selling price per yard, $1.83, which is the amount given as the representative selling price.

		Estimated	Actual	Excess of actual over estimated
Cost per yard:				
Raw material		$.89	$.8918	$.0018
Direct labor—				
Weaving—piece work	$.38			
Winding, warping, etc.	.03			
Total direct labor		.41	.4364	.0264
Foremen and supervision		.10	.1936	.0936
Total		$1.40	$1.5218	$.1218
Factory and office overhead		.21	.4525	.2425
Total		$1.61	$1.9743	$.3643
Profit—per estimate		.22		
Loss sustained			.1443	.3643
Selling price per yard		$1.83	$1.83	

(An inquiry into the method followed and an investigation of the details making up the estimate should be made.)

A further analysis of the raw-material account shows that, based on a cost of $.89 per yard, 2,247 yards are unaccounted for.

	Amount	Yards
Inventory, January 1, 1927	$157,000	176,404
Purchases	1,200,000	1,348,315
Total	$1,357,000	1,524,719
Inventory, December 31, 1927	376,000	422,472
Raw material used	$981,000	1,102,247
Yards sold		1,100,000
Unaccounted for		2,247

The amount unaccounted for approximates 2 per cent. of the production for the year, and may reasonably be assumed to be due to waste or shrinkage in process.

While the actual amount of piece-work labor (weaving) is not given and, hence, can not be checked against the estimate, it may be assumed that the rate used in the estimate ($.38) is correct. The week-work labor estimate was, therefore, understated $.0264 per yard.

The estimates for foremen and supervision, and factory and office overhead were understated $.0936 and $.2425 per yard, respectively, a total of $.3361 per yard or $369,710 on sales of 1,100,000 yards. The estimate does not show any provision for depreciation.

In this solution it is assumed that the amounts and data given are correct. In practice, the accountant should insist that the accounts be verified. While it would appear from the analysis that the loss was due to the practice of basing selling prices on estimates which later proved to be inaccurate, it is possible that a portion of the loss is the result (1) of treating extraneous charges as current expenses, (2) of writing off replacements of other capital charges to operations, (3) of padded payrolls, (4) of excessive salaries, or (5) of inaccuracies in inventories.

A survey of the plant and operations may disclose possible reductions in the overhead cost and a possible saving in the handling of inventories. The inventory at December 31, 1927, of $376,000 is more than 38 per cent. of the total material used during the year, approximately enough to meet the requirements of the next four months.

A cost system, simple to operate and yet comprehensive in scope, could be devised and should be recommended as a means of preventing a repetition of such conditions in the future.

If the management, however, will not consent to the installation of such a system and requests the accountant to submit a revised estimate, the following may be presented:

Cost per yard:		
Raw material		$.8918
Direct labor—		
Weaving—piece work	$.3800	
Winding, warping, etc.	.0564	
		.4364

Foremen and supervision	$.1936
Total	$1.5218
Factory and office overhead (30% of $1.5218)	.4565
Total	$1.9783
Profit (12% of $2.25)	.2700
Selling price	$2.25

The management should be cautioned to check the estimate monthly and to revise it immediately if conditions change. It is not known what effect a price of $2.25 will have upon the sales volume.

No. 3 (27 points):

Commencing an audit, during February, 1928, of the books of account of the A B C Manufacturing Co. for the year 1927, the balance-sheets following, prepared by the bookkeeper, were presented to you:

A B C MANUFACTURING COMPANY

BALANCE-SHEETS

Assets	December 31, 1927	1926
Land	$40,000	$40,000
Buildings	225,000	175,000
Machinery and equipment	112,000	100,000
Tools	13,500	12,000
Patents	48,000	50,000
Unamortized bond discount	4,750	
Prepaid operating services and supplies on hand	6,250	7,500
Marketable securities		25,000
Cash	52,000	35,000
Accounts receivable	160,000	150,000
Raw materials	70,000	60,000
Goods in process of manufacture	30,000	35,000
Finished goods	100,000	110,000
Totals	$861,500	$799,500
Liabilities		
Bank loans	$10,000	$40,000
Notes payable	5,000	10,000
Accounts payable	62,000	70,000
Bonds	100,000	
Reserves:		
For depreciation of building	21,500	17,500
" " " machinery	48,800	44,500
" bad accounts	4,200	3,000
Capital stock	500,000	500,000
Surplus	110,000	114,500
Totals	$861,50	$799,500

In the course of the audit, it was ascertained that

(a) Additions to buildings, actually costing $35,000, were set up on the books at $50,000, based upon unaccepted bids by outside contractors.

(b) Machinery, costing $10,000, was sold for $3,000. The accrued depreciation on these machines amounted to $5,800 and the loss was charged against surplus.
(c) The bonds were issued on July 1, 1927, at 95. They mature in ten years and interest at six per cent. is payable semi-annually.
(d) Tools, costing $4,000, were acquired during the year and the account was adjusted to a fair value, December 31, 1927.
(e) The marketable securities were sold during the year for $32,000.
(f) Four quarterly dividends of one and one half per cent. were paid during the year.
(g) Depreciation of buildings at two per cent. was computed on $175,000 for six months and on $225,000 for the other six months.

Relative to the foregoing, prepare surplus account showing result for the year after making any adjustments you think necessary; also prepare statement showing the changes in the accounts resulting from adjustments of surplus and reserves and show the working capital at December 31, 1927.

Solution:

The following is an explanation of the adjustments made in the working papers on pages 152 and 153.

Explanation of adjustments

(a) Reverses the entry for the write up of additions to buildings to $50,000 (based upon the unaccepted bids by outside contractors). This entry eliminates the write up from the buildings account.

(b) Transfers the entry for the profit of $7,000 realized from the sale of the marketable securities from the surplus account so that the amount received for the securities may be carried out as a separate item, as a fund provided.

(c) Transfers to a separate line the charge to surplus account for the four quarterly dividends of one and one half per cent. paid during the year so that these dividends may be carried out as a separate item, as a fund applied.

(d) Transfers the loss on sale of machinery to machinery account so that funds provided for the purchase of additional machinery may be determined.

(e) Transfers to a separate line the net profits for the year from surplus account so that the net profits may be carried out as a separate item, as a fund provided.

(f) A memorandum entry proving that all the items causing the net decrease in surplus ($4,500) have been separately accounted for.

(g) (h) Transfers the following depreciation from the reserves to funds provided by profits:

(g) on buildings	$4,000.00
(h) on machinery and equipment	10,100.00

(i) Transfers to funds provided by profits the amount of tools written off to adjust the tools account to a fair valuation.

(j) Transfers the bond discount amortized to funds provided by profits.

(k) Transfers the amount of patents written off to funds provided by profits.

(l) Adjustment to set up the amount of bond interest accrued at December 31, 1927.

(m) Records the funds provided by sale of machinery.

(n) Reverses the amount of accrued depreciation on machinery sold—depreciation which was charged to the reserve account.

(o) Transfers the amount of discount on bonds to bonds account to set out the funds provided by the sale of bonds.
(p) Transfers the increase in reserve for bad accounts to accounts receivable to set out the net increase in the latter.

A B C Manufacturing Company

Statement of application of funds for the year ended December 31, 1927

Funds provided:			
By net profit—			
Net profit per books	$4,700		
Less: Interest accrued on bonds	3,000		
Adjusted net profit		$1,700	
Add: Depreciation—			
Buildings	$4,000		
Machinery and equipment	10,100		
Tools	2,500		
		16,600	
Amortization of patents		2,000	
Bond discount amortized		250	
			$20,550
By sale of machinery:			
Cost	$10,000		
Less: Accrued depreciation	5,800		
		$4,200	
Less: Loss on sale		1,200	
			3,000
By sale of marketable securities:			
Cost		$25,000	
Add: Profit on sale		7,000	
			32,000
By issue of bonds:			
Par		$100,000	
Less: Discount		5,000	
			95,000
Total funds provided			$150,550
Which were applied as follows:			
To purchase of fixed assets—			
Buildings		$35,000	
Machinery and equipment		22,000	
Tools		4,000	
			$61,000
To payment of dividends			30,000
To increase in working capital and prepaid expenses			59,550
Total funds applied			$150,550

A B C MANUFACTURING COMPANY

Application of funds—working papers

Assets	Years ended December 31, 1927	1926	Year's excess Debit	Year's excess Credit	Adjustments Debit	Adjustments Credit	Working capital Increase	Working capital Decrease	Funds Applied	Funds Provided
Land	$40,000	$40,000								
Buildings	225,000	175,000	$50,000			(a) $15,000			$35,000	
Machinery and equipment	112,000	100,000	12,000		(d) $1,200					
					(n) 5,800					
					(m) 3,000				22,000	
Tools	13,500	12,000	1,500		(i) 2,500				4,000	
Patents	48,000	50,000		$2,000	(k) 2,000					
Unamortized bond discount	4,750		4,750		(j) 250	(o) 5,000				
Prepaid operating services and supplies on hand	6,250	7,500		1,250				$1,250		
Marketable securities		25,000		25,000		(b) 7,000				$32,000
Cash	52,000	35,000	17,000				$17,000			
Accounts receivable	160,000	150,000	10,000			(p) 1,200	8,800			
Raw materials	70,000	60,000	10,000				10,000			
Goods in process of manufacture	30,000	35,000		5,000				5,000		
Finished goods	100,000	110,000		10,000				10,000		
	$861,500	$799,500								
Liabilities										
Bank loans	$10,000	$40,000	30,000				30,000			
Notes payable	5,000	10,000	5,000				5,000			
Accounts payable	62,000	70,000	8,000				8,000			
Bonds	100,000			100,000	(o) 5,000					95,000
Accrued interest on bonds						(l) 3,000		3,000		
Reserves:										
For depreciation of building	21,500	17,500		4,000	(g) 4,000					
For depreciation of machinery	48,800	44,500		4,300	(h) 10,100	(n) 5,800				
For bad accounts	4,200	3,000		1,200	(p) 1,200					
Capital stock	500,000	500,000								
Surplus	110,000	114,500	4,500			(f) 4,500				
	$861,500	$799,500	$152,750	$152,750						

	Entries during year Debits	Credits						
Analysis of surplus changes:								
(Reversing all debits and credits)								
Appraisal increase in value of buildings		$15,000	(a) $15,000					
Profit on sale of marketable securities.		7,000	(b) 7,000					
Dividends paid	$30,000			(c) $30,000				
Loss on sale of machinery	1,200			(d) 1,200				
Net profit for the year		4,700	(e) 4,700					
Net decrease		4,500	(f) 4,500					
	$31,200	$31,200						
Cash dividends paid			(c) 30,000				$30,000	
Net profit for year				(e) 4,700				
Depreciation written off—								
Buildings				(g) 4,000				
Machinery and equipment				(h) 10,100				
Tools				(i) 2,500				$20,550
Bond discount amortized				(j) 250				
Amortization of patents				(k) 2,000				
Bond interest accrued			(l) 3,000					
Funds provided by sale of machinery				(m) 3,000				3,000
			$99,250	$99,250				
Increase in working capital						59,550	59,550	
					$78,800	$78,800	$150,550	$150,550

A B C MANUFACTURING COMPANY

Schedule of working capital and prepaid expenses December 31, 1927, and December 31, 1926

	December 31, 1927	December 31, 1926	Working capital Increase	Working capital Decrease
Current assets:				
Cash	$52,000	$35,000	$17,000	
Accounts receivable (net)	155,800	147,000	8,800	
Raw materials	70,000	60,000	10,000	
Goods in process	30,000	35,000		$5,000
Finished goods	100,000	110,000		10,000
Total current assets	$407,800	$387,000		
Current liabilities:				
Bank loans	$10,000	$40,000	30,000	
Notes payable	5,000	10,000	5,000	
Accounts payable	62,000	70,000	8,000	
Accrued interest on bonds	3,000			3,000
Total current liabilities	$80,000	$120,000		
Working capital	$327,800	$267,000		
Increase in working capital				60,800
			$78,800	$78,800
Increase in working capital			$60,800	
Decrease in prepaid operating services and supplies on hand			1,250	
Net increase			$59,550	

Schedule 1

A B C MANUFACTURING COMPANY

Analysis of surplus account for the year ended December 31, 1927

Balance, January 1, 1927		$114,500
Add:		
Profit on sale of marketable securities		7,000
Profit per books	$4,700	
Less: Interest accrued on bonds at December 31, 1927 (3% on $100,000)	3,000	
Adjusted profit (schedule 2)		1,700
Depreciation on appreciation of buildings (1% on $15,000)		150
Total		$123,350

Deduct:			
Loss on sale of machinery		$1,200	
Dividends paid		30,000	
			$31,200
Adjusted balance, December 31, 1927			$92,150

Schedule 2

A B C Manufacturing Company

Statement showing computation of adjusted profits for the year ended December 31, 1927

Funds provided by profits (per working papers)			$20,550
Deduct: Charges to profit and loss:			
Bond discount amortized		$250	
Provision for depreciation:			
Buildings	$4,000		
Machinery and equipment	10,100		
Tools	2,500		
		16,600	
Amortization of patents		2,000	
Total deductions			18,850
Adjusted profit for the year ended December 31, 1927			$1,700

Note.—The depreciation on the amount of the write up of the buildings may be adjusted against operating profits or surplus account.

Schedule 3

A B C Manufacturing Company

Reserve for unrealized profit on appraisal

Appraisal increase in value of buildings (Transferred from surplus account)	$15,000
Less: Depreciation on the appreciation (1% on $15,000)	150
Balance, December 31, 1927	$14,850

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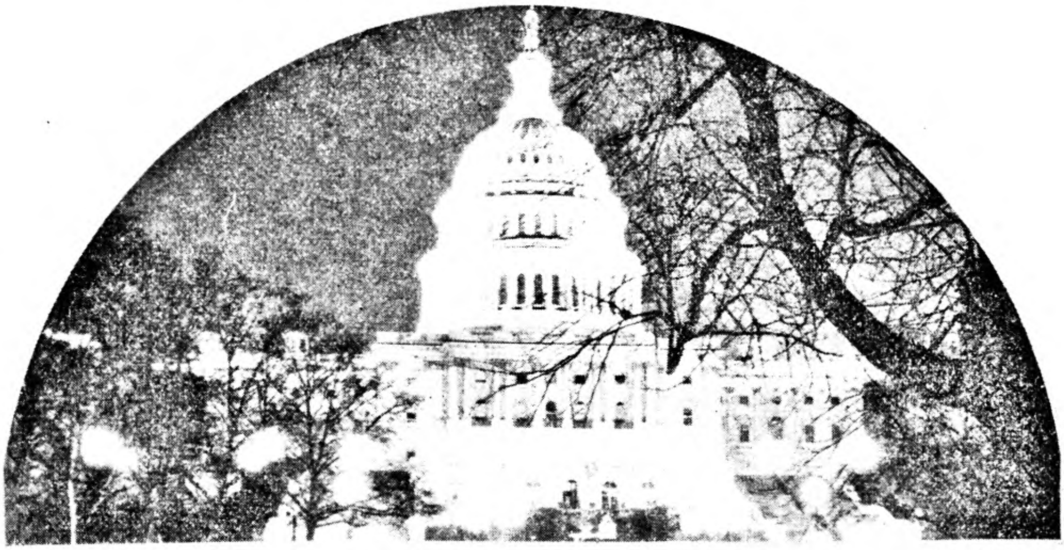

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